An Analysis of the Practice of Public Accounting in Ontario

Prepared by
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for
The Professional Organizations Committee

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AN ANALYSIS OF THE PRACTICE
OF PUBLIC ACCOUNTING IN ONTARIO

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INTRODUCTION

SUMMARY AND OVERVIEW

Our objective in this study is to present evidence that will be useful to the Professional Organizations Committee in its deliberations over the rights to practise public accounting in Ontario. The principal issue that we address is "which of the range of functions currently performed by accountants require regulation (if any)?" It is important to note at the outset that we are not concerned with prescribing how accountants ought to be performing their functions. The actual practice of accountancy is a matter that must be addressed by the various professional bodies themselves. The issues facing public accountants in Canada are conveniently summarized in the Adams Report (1978) and in its U.S. counterpart, the Cohen Commission Report on Auditors' Responsibilities (AICPA, 1978). On the other hand, we are sensitive to the fact that the regulatory environment can have a profound effect on the evolution of the profession within regulatory constraints.

We know of no other jurisdiction in the world where the practice of accounting is more regulated than in Ontario. Regulation is both indirect and direct. Corporations acts provide indirect regulation by providing that many corporations must be audited and that the accounting principles used by corporations must be those prescribed by the CICA: there is no other jurisdiction in which a higher proportion of corporations must have audits. The Public Accountancy Act provides direct regulation. It defines

"public accounting" very broadly as being any activity that may lend credibility to financial information, and restricts the practice of public accounting to licensees. Each revision of the Act has excluded certain kinds of accountants from practice from the date of the revision onward. Some accountants, for example, RIA's, have not contested the revisions, but have specialized in other branches of accounting, such as management accounting. Others, particularly CGA's, have appeared to be reasonably satisfied at the date of revision -- probably because of the so-called "grandfather clauses" allowing existing practitioners to go on practising regardless of designation. As the younger members of the excluded designations have matured, however, conflicts have surfaced once again over rights to practise.

The route to practise in Ontario now is to become a Chartered Accountant. This requires a university degree (usually), certain professional course requirements, and a two- or three-year internship with a public accounting firm that is accredited by the ICAO to train students, during which time the student's progress is monitored by the Institute. Fewer than half of the CA's in Ontario practise public accounting, yet any CA may be licensed to practise on payment of a nominal fee. Other kinds of accountants need not, though they may, obtain a university degree or intern with a public accountant in order to attain their designations.

Clearly, there are issues at stake that extend far beyond the scope of our work. For example, are the audit requirements in the corporations acts worth preserving? In order to come to grips with the problem of reform of the public accounting institution, however, we had to take certain other institutions as given. Therefore, when we discuss auditing, we mean auditing as it is defined in the CICA Handbook and as it is alluded to in the present corporations acts. If these institutions were to vary simultaneously with The Public Accountancy Act, our analysis would have to be modified.

In drawing out the public policy implications of our findings, we have been unable to reach agreement. Fred Lazar and Marc Sievers, as they state in Chapter 4, favour de-licensure of public accounting. They argue that there is no evidence to indicate that anyone is worse off in the unlicensed jurisdictions than in the licensed ones described in Chapter 3. Indeed, they posit that the public may be better off in an unlicensed environment because they would be freer to trade off price versus quality of accounting services. If certain accountants are better than others, they feel that the market will reward them and will come to recognize the differences in ability implied by the various designations. Daniel Thornton has less faith in the working of the invisible hand. He interprets the evidence here as indicative that many clients and most users of accounting information are unable to assess the trade off between price and quality. He favours the

development of a strong public accounting profession whose members can help their clients make the assessment, and who are sensitive to the needs of users. He recommends partial de-licensure that would involve licensing for audits and reviews, but would allow anyone to prepare financial statements without review. Ontario, in Thornton's view, is a big province in the development of public accounting in Canada. To de-license totally in Ontario would open the door to the growth of two or more standards of public accounting on a national basis, since there appears to be little or no hope for any sort of merger between CA's and CGA's. Whether this would be desirable or not is debatable: Thornton believes it would not be.

Of course, once the recommendation to retain licensing is made, the question that immediately arises is, "who should be licensed?" Here Thornton is of the opinion that to award licences solely on the basis of any particular accounting designation is too arbitrary an approach. The evidence in this report makes clear that activities of accountants serving small clients differ markedly from those of accountants serving large clients. Different kinds of training may be appropriate for accountants who wish to practise in different segments or even different geographic locations. The main problem with the current licensing regime is that licences appear to be too easy to obtain and to keep for CA's, and too difficult for others. As a result, it is quite possible that there are CA's practising who are not currently

up to date in their understanding of the licensed functions. It is also possible that there are some other kinds of accountants who are (or could be) qualified to practise but who cannot obtain licences. CA's point out that these other accountants can always enrol in the CA program and eventually become licensed CA's themselves. This is true, but we must question whether it is reasonable to expect them to be able to obtain the university credits, particularly in Toronto where part-time accounting courses in universities are overcrowded. We also must question whether such rigour is required to train these people for the kind of work they wish to do. If they wish to audit General Motors, we would certainly say yes. If they wish to perform reviews of small clients, perhaps not.

Some sort of certification board, composed along the lines of the Auditor Certification Board in British Columbia, may be a reasonable solution to these problems. Such a board would award licences to be renewed every two years (as in New York and California) on the basis of accounting designations and demonstrated competence. This Board would issue licences for public accounting (audits and reviews), not only auditing as is the case in British Columbia. And it would allow for flexibility in the awarding of licences, taking into account the fact that different standards may be appropriate in different market segments, but taking care to avoid the development of multiple standards within segments. A licensing board might also allow flexibility in trading off

training versus experience requirements. For example, the essential ingredient of the CA program is the internship requirement. A certification board might be able to work out some program whereby non-CA's could be licensed after some internship that would be longer than that of a CA student.

A number of thorny administrative problems arise in Thornton's model which are, of course, absent from the "de-licensure" model of Lazar and Sievers. One major question is that of the composition of the Board: what is implied is a re-constituted Public Accountants' Council comprising appointees of the ICAO, the CGAAO, the SMAO and perhaps the Lieutenant-Governor-in-Council, as in B.C. The proportions in which these bodies ought to be represented is a matter of judgment and negotiation. The monitoring costs involved in an effective re-certification program are high, and the question of which body or bodies ought to bear these costs is another important one. (It is interesting to note that both the Adams Report and the Cohen Commission Report advocate "peer review", whereby auditors are in some way audited by other auditors. The objective of such a review would be to ensure that practitioners were neither over-serving nor under-serving their clients. Without such a process, there is absolutely no guarantee that the output of the practitioners is satisfactory.)

Finally, related to the problem of monitoring is one which has plagued the current system and one which would have to be resolved

under a re-constituted Board: namely, the duplication of disciplinary actions.

All three researchers agree that total de-licensure would have little or no effect on the large- and medium-size CA firms or their clients, although Thornton feels that there is the chance that in the very long run large national CGA firms could arise and foster the dual development of accounting and auditing principles that he finds undesirable. In the small segment, Thornton disagrees again with Lazar and Sievers, and fears that it might become unprofitable for practitioners to render high quality reviews. If more than one standard is allowed, low standards may tend to drive out high ones. Lazar and Sievers feel that the market would look after these problems adequately: users would demand proper quality and liability insurance would be more expensive for accountants whose designations implied lower quality. This would be especially likely in Canada, where banks form a particularly oligopolistic group of users.

We view our lack of agreement as a strength rather than a weakness of this study, for it serves to point out more clearly certain arguments that may be relevant to the Professional Organizations Committee. This document is only one input that the Committee will consider in its deliberations. The principal contribution that we, as researchers, can make is to build as good an empirical description as possible of the profession and its stakeholders, so that the Committee can speculate intelligently

on the effects of the suggestions that the various special interest groups may make during hearings. This we believe we have done.

This overview section summarizes what we did, what we found out, and what we recommend. We are presenting only highlights, here, however, and those who wish a fuller picture are referred to the main body of our report. In particular, we would point out that, while our regressions identified a number of factors which are very clearly related to the performance of public accounting firms there remains a sizeable "random" component to their behaviour; there are other factors at work which we have not identified. Thus, although we are able to make certain "generalizations", it is important to note that there are numerous exceptions to the rule. Of course, we disclose all of our statistics in the body of the report. The reader is encouraged to make his or her own judgments about our results.

What We Did

This paper consists of three chapters, supported by confidential appendices. Chapter 1 attempts to assess the impact of public accounting on society by means of a literature review of both professional and academic publications. Chapter 2 describes the industrial organization of public accounting in Ontario. Data for Chapter 2 were collected from five main sources:

1. a firm survey mailed to all public accounting firms in Ontario, which was analyzed by computer using the Statistical Package for Social Scientists (SPSS);

2. firm interviews carried out by the authors in which practitioners in large, medium and small public accounting firms were consulted face to face;

3. user interviews carried out by the authors in which a limited number of financial statement users (chartered bankers, security analysts, and an official from the Federal Business Development Bank) were consulted face to face;

4. client interviews performed by Ms. Janet Myers, our research assistant, in which a sample of small, medium, and large clients were interviewed either face to face or by telephone (the sample of some firms having been randomly selected by Dun & Bradstreet); and

5. interviews with various officials in the ICAO and CICA conducted by the authors. Particularly useful was our interview with the ICAO's small practice advisors.

Chapter 3 compares accounting legislation in various other jurisdictions with that in Ontario. We selected four provinces and two states for comparison.

What We Found

From Chapter 1 we observe that public accounting standards can affect economic behaviour; therefore, accounting choice can redistribute wealth. Although this would seem to argue for government involvement in standard setting, there exists no government agency with the technical competence to resolve the complex public accounting issues facing large corporations or with the sensitivity and experience required to deal with the special public accounting problems facing small businesses. We point out that direct involvement of the government in accounting standard setting would create a possible conflict of interest, since accounting standards influence macro-economic performance measures in which governments have an interest. It is also likely that a profession that has the autonomy to set its own standards will attract better practitioners who are more willing and able to respond to accounting problems as they arise in the various sectors.

In Chapter 2 we describe the accounting profession in Ontario. We could not perform a routine industrial organizations study because we could not measure the output of the accounting firms: therefore, we could not observe prices in the market. Most sources that we consulted described output as "lending credibility to financial information." For large corporations, audits are prescribed by statute, so we were unable to observe or even speculate on the possible trade offs a client might make between

audit costs and borrowing costs. For smaller clients, bankers are often the real source of the demand for public accounting services: and since banks in Canada are not competitive, their demands tend to have the same sort of effect as if audits and reviews were statutory for small clients too. Clients demand other advisory services directly from public accountants to meet after-tax profit objectives. The demand for these services usually arises during a public accounting engagement and almost invariably is met by the same public accountant.

We observed on the supply side a one-way segmentation of the market by size of accounting firm and on the demand side a two-way segmentation by size of client and service demanded, as the following table shows:

Dominant Public Accounting Firms

Service / Client	Auditing	Other
Large clients	Large CA firms	Large CA firms
Small clients	Large and small PA firms	Small PA firms

Large firms do much more public accounting than small ones, and tend to specialize in auditing. Small firms tend to view their primary responsibility as client satisfaction, and spend much more of their time giving advice on taxation, estate planning, bookkeeping, accounting, and business in general. Firms with

head offices in cities, especially Toronto, tend to do more public accounting than rural firms, which generally specialize in advice-giving to small businesses. Over half of our respondents were one-man firms that did little or no auditing. Unfortunately, we grouped review and non-review engagements in the questionnaire under the heading "other public accounting." It would have been much more useful to the Committee if we had grouped audits with reviews and collected information on non-review engagements separately. We estimate that a very substantial portion of the work done by small firms is non-review work, but we have no data to back this up. Nevertheless small (one- and two-man) firms earn 60% of their fees from clients paying less than $1,000. This implies only three or four man-days per client per year: hardly time for a full review engagement, when one considers that much of this time is spent giving general business advice, etc.

There is no evidence of excess supply of public accountants in Ontario. Most firms are at or near capacity. Small firms in particular face an irregular work load. We concluded that it must be exceedingly difficult for them to render high quality service during peak demand times. Large firms have more specialists available to their employees and are undoubtedly in a position to render technically superior service. Many small clients and users, however, seem willing to trade off quality for promptness. The comparative advantage of the small firms is that they are willing to render quick service. The few

CGA firms in Ontario compare roughly with small CA firms, except that they spend more time doing bookkeeping and less doing public accounting. There are no large CGA firms in the province, for obvious reasons.

When a client seeks a public accountant, he or she seldom has any idea of how billing rates vary across public accounting firms. Small- and medium-size clients usually are referred by a lawyer, banker, or friend. Large clients are generally constrained to use one of the large internationally recognized firms, since only these firms offer sufficient credibility in capital markets. (These are generally the Canadian affiliates of the "Big Eight" U.S. accounting firms.) Despite this, clients told us that they had adequate information on which to base their selection. Once hired, a public accountant is seldom fired. Re-appointment is usually an automatic or a rather perfunctory process. Nonetheless, when clients are dissatisfied with service they do not hesitate to switch accountants. Thus the relationship between the public accountant and his or her client tends to be a long one. Small firms sometimes charge new clients a rather low hourly rate to begin with, hoping to recover higher fees later. We found extremely little evidence of dissatisfaction among clients. Small clients were particularly laudatory when discussing their relationship with their public accountants. Very few clients felt overcharged.

Almost none of the clients or users understood the meaning of the various types of accountants' reports outlined in the CICA Handbook. As a result, they were ignorant too of how much work a public accountant would have to do to justify a certain type of opinion. Therefore, they must rely on the ethics of the profession to counteract the economic incentives to over-serve or under-serve. Some large corporations have audit committees of their boards of directors which purport to review the auditor's work periodically. Smaller clients have neither the knowledge nor the time available to monitor their accountants. Switching occurs most often when the client "outgrows" the public accountant and needs more sophisticated services in taxation or general business advice. Switching often occurs also when the client begins selling securites to the public: then, investment bankers usually advise them to retain a Big Eight firm.

Only five firms with over 150 CA's replied to our questionnaire, of the ten or eleven firms in this category in the province (including the Canadian affiliates of the U.S. "Big Eight"). In general, we noted that our response rate was better, the smaller the respondent category. No doubt, the larger firms found it much more difficult and costly to fill out the questionnaire than the small ones. As a result, our data suffer from non-response bias. Nevertheless, it is evident that the profession is very highly concentrated. Of some 800 respondents, five firms had about 40% of the CA's and

half the students. The largest firms charge the highest rates, attract the best students, and have practitioners with significantly more formal education than other public accounting firms. This structure has developed to service the large client segment, where the public accounting problems are most complex and the most auditing manpower is required.

We were somewhat surprised to find that a number of the clients who purchased audits mentioned that they felt a primary reason that they did so was for internal use. That is, the audit improved the client's "internal control."

All clients were aware that an accounting designation implied some expertise, but almost no small clients were able to discriminate among CA's, CGA's, etc. Large clients were more aware of the differences in background implied by the designations, since usually their chief financial officers were professional accountants themselves. However, recall that bankers are often very influential in matching accountants with clients. Bankers are generally better informed than the small clients and tend to steer their customers toward CA firms.

There is some evidence that the profession can be described in terms of a "price-leadership" model. The large firms tend to set the norms for billing rates, student salaries, etc.; then the smaller firms charge somewhat less. However, an important point to note is that the hourly rates are not

necessarily good indicators of prices, since there is no guarantee that two accountants charging the same rate will provide the same service. One may be slower or faster in his work, or he may decide that he has to collect more or less evidence to express the same opinion. Indeed, he may decide that his client should have a completely different set of services.

It is for these reasons that Thornton, in particular, feels that it is dangerous to rely solely on the market mechanism to allocate accounting services: ignorance of clients and users and the latitude that practitioners have in prescribing services.

Chapter 3 reviews accounting legislation in Quebec, Saskatchewan, Alberta, British Columbia, California, and New York. We conclude that the regulatory regime depends upon the history of the jurisdiction, the attitude of the government, the relative numbers of the various kinds of accountants, and the type of economy.

In Quebec, CA's have exclusive rights to practise public accounting, whose definition is similar in essence to the one in the Ontario law. CGA's and RIA's have exclusive rights to use their designations, but can engage in public accounting only with certain specified clients. In Alberta and Saskatchewan, there is no regulatory legislation because the

accountants cannot agree on its prospective form and the governments are generally not convinced that legislation is needed. We review the Chichak and Lowry reports in those two provinces and conclude that the accountants generally feel the same way there as in Ontario: it is the governments whose attitudes, historically, have differed. In British Columbia, anyone can do any kind of public accounting except auditing. Auditors must be certified by an Auditor Certification Board. Both CA's and CGA's were certified as a group, but APA's and others must apply singly. There have been very few applications. The Board "may certify an applicant subject to such terms and conditions as it considers advisable", and may consider such factors as <u>location</u> of demand for audit services in assessing an application. We reviewed merger talks that occurred in British Columbia and eventually broke down between CA's and CGA's. It appears that a major reason for the prominence of CGA's in British Columbia is that the University of British Columbia has an intimate tie with CGA's: faculty there have designed the national CGA course of study and accept CGA graduates as undergraduate equivalents.

In New York and California, practitioners must be licensed; but, as in British Columbia, the professional organization is not directly involved in the State Boards that grant the licences. In effect, though, the sole route to practise now is to become a CPA, the American equivalent of a CA. Both

states require periodic re-licensing. New York accepts a fifteen-year internship program as a substitute for a university degree, and is somewhat flexible as to acceptable mixes of education and experience. Interestingly, CPA's do not write the same qualifying examinations in different states. This is in contrast to the uniform final examination that is written by all CA candidates in Canada. New York is a particularly interesting state to study because Ontario's definition of public accounting was based on the New York one.

Thus we have quite an array of regulatory schemes. Each scheme seems to be working in its jurisdiction. Unfortunately, we are unable to assess the relative performance of accountants in these jurisdictions because we are unable to measure the output of public accountants. At first we thought of trying to devise some proxy, such as the incidence of tax re-assessments among clients of CA's and CGA's in British Columbia. It soon became apparent, however, that such information would be extremely difficult to get. In addition, there is often a long time lag before the effect of good or bad service is felt and it is difficult or highly subjective to make the association between the input and the output. The best we can do is to point out that public accounting appears to be functioning satisfactorily in these jurisdictions. And once institutions are established to provide public accounting services, it is very difficult to change them. In fact, the way people view public accountants is to some extent a function of the institutional

rules that are established. Therefore, if we wish to reform these explicit institutions we must take into account the cost of reforming implicit ones as well: the costs of changing people's minds, upsetting rules of thumb, and the like. The only evidence we can bring to bear on this problem is anecdotal. When we interviewed a senior bank executive last summer who had worked in both British Columbia and Ontario, we asked whether the different legislation in the two jurisdictions had any effect on him as a banker. To this he responded that he was not even aware that the legislation was different.

CHAPTER 1

AN ASSESSMENT OF THE INFLUENCE OF PUBLIC ACCOUNTING

In this chapter, we attempt to assess the influence of public accounting on behaviour, particularly economic behaviour, with the objective of identifying issues that are of importance in considering public policy alternatives. The first section outlines some competing hypotheses concerning the efficiency of capital markets in which consideration is given to whether, and if so, to what extent public accounting affects economic behaviour. The second section considers how public accounting may affect economic behaviour. The third section discusses the conflict between technical competence and social legitimacy that may face any organization that wishes to establish standards and procedures for public accounting.

By public accounting in this chapter, we shall mean financial accounting, auditing, and any other activity that in some way lends credibility to financial information. The Canadian accountant, Skinner defines financial accounting as "a medium of communication of pertinent economic information by those responsible for managing an entity to other parties (owners, investors, creditors and the public generally) having an interest in it but who do not have access to its internal information systems."[1] Financial accounting standards govern disclosure (i.e. what entities must report) and measurement (i.e. how they must describe their economic operations). These are summarized in the CICA Handbook and to some extent rationalized by Skinner. Auditing standards govern the rules

for validating the economic information that appears on financial statements. These are also summarized in the CICA Handbook and explained more fully in Anderson.[2] Section 8100 of the CICA Handbook outlines the standards relating to the major other activities that lend credibility to financial information: review and non-review engagements. The Handbook also contains "accounting and auditing guidelines" specifying the public accountant's role in such activities as auditing a candidate under The Canada Elections Act, accounting for the effects of changes in the purchasing power of money, and ensuring compliance with federal anti-inflation legislation. In addition, it should be noted that public accountants have rules of professional conduct that are to be followed in all of these activities. In Ontario, the most important ones are those of the Institute of Chartered Accountants of Ontario.

It seems clear to us that public accountants, by dint of the scope of their activities, have the opportunity to influence economic behaviour.

I. SOME COMPETING HYPOTHESES

In this section we review some of the literature and empirical work dealing with the efficient markets/rational expectations hypothesis, the naive investor hypothesis, and what we have chosen to call the market segmentation hypothesis, in which it is posited that some markets may be efficient and others not.

1. Efficient Markets/Rational Expectations Hypothesis

The efficient markets hypothesis is that security prices fully impoint all publicly available information. The literature can be traced from Muth's[3] early paper on the theory of rational expectations. In fact, the efficient markets literature summarized by Fama[4] can be viewed as a special branch of the rational expectations literature reviewed by Poole[5] and by Sargent and Wallace[6]. Implications for accounting are summarized conveniently in Dyckman[7] and in Lev[8].

An extreme interpretation of this literature would lead one to suppose that public accounting is unnecessary, since the public would eventually learn everything necessary to price securities at their intrinsic values (equilibrium prices); or to determine consumption/investment patterns that fully took into account whatever policies a government might implement.

Although the literature is convincing, its empirical tests have been confined largely to observing price movements of shares of public companies trading in a well-disciplined auction market, nearly always the New York Stock Exchange. Fewer than 8% of Canadian businesses are public companies, and very few are listed on a stock exchange. To the best of our knowledge, no attempt has been made to test the efficiency of the market for securities of non-public companies: nor is one forthcoming, since there is no orderly market on which these securities

trade that might be used to validate a test. In short, the efficient markets literature is probably irrelevant to public accounting policies for the vast majority of public accounting clients.

As for publicly traded companies, we are of the opinion that the literature may have considerable application in establishing accounting policies. For if markets are efficient, many of the debates over alternative accounting policies are irrelevant: if the costs of two alternative modes of disclosure are equal, market participants should not care which mode is adopted as long as full disclosure is made. There is considerable evidence that the choice between accounting principles is arbitrary anyway, since arbitrary allocations are involved.[9] We believe that public accountants involved in establishing accounting standards or practising in firms with publicly traded clients should be well-versed in this literature. Its application in this paper, however, is restricted for at least three reasons. First, considerable ad hoc evidence can be produced of "inefficiencies": i.e., cases where the selection of accounting principles affected economic behaviour of large publicly traded companies (see Section II). Second, all empirical tests of capital market efficiency are predicated upon some equilibrium model of security pricing: to date there seems to be significant doubt among theoreticians as to the practicability of these equilibrium models.[10] Since each test of efficiency is in reality a joint test of (a) the equilibrium model and (b) market efficiency, given this model, we would have to con-

clude that results to date are too tentative to use as a basis for establishing public accounting policy. Third, rational expectations is a macro theory: the dynamics involved in going from one set of equilibrium security prices to another has not been considered. Even if the hypothesis were true for public companies in the comparative static sense, it is impossible to speculate on the desirability of the dynamics with and without public accounting information as we now know it. We suspect that small investors might be relatively less well-off in the absence of public accounting data before equilibrium was established (if indeed equilibrium were ever reached).

2. Naive Investor Hypothesis

This hypothesis is antithetical to the efficient markets/rational expectations hypothesis. One statement of it might be that investors react myopically to accounting reports: that they take accounting numbers at face value without further questioning. Suppose, for example, that there were two identical firms offering securities for sale to the public, and that one chose to depreciate its assets more quickly on its financial statements, showing lower net income per share than the other. A naive investor might pay more for the shares of the other company. Of course, this would be totally irrational (in the absence of tax benefits to accelerated depreciation), but many examples can be found of firms or investors who assume this sort of inefficiency.

An example that has received much publicity relates to Statement No. 8 of the Financial Accounting Standards Board (FASB) in the United States. This statement required companies to show the effect of foreign currency fluctuations on their quarterly earnings statements. Several multinational companies claimed that this necessitated inefficient currency hedging to dampen currency fluctuations.[11] Philip Morris refused to restate its 1975 earnings to compare with 1976, saying that the comparison would show "an artificial rise in profit". Consider the following excerpt from Philip Morris' report to shareholders for the quarter ended March 1976:

> "Under these new accounting rules, the company's exposure to foreign currency movements is increased, so the scope and nature of appropriate hedging activities is now substantially enlarged from those appropriate under former rules."

Other examples are considered by Prakash and Rappaport[12] relating to business combination accounting, price-level accounting, full cost accounting in the oil industry, self-insurance accounting, and early extinguishment of debt. These examples do not prove that markets are not efficient; however, they do indicate that many participants in the market are <u>assuming</u> inefficiency of some sort. We shall have more to say about such examples in Section II of this chapter, where the concept of information inductance[13] if discussed.

3. <u>Market Segmentation Hypothesis</u>

This hypothesis is devised by the authors of this paper to attempt to explain certain phenomena in Ontario that may be

relevant to the Professional Organizations Committee. It appears that there are at least two segments in the public accounting market on both the supply and demand sides. One segment consists of large business corporations audited by large CA firms; the other, smaller economic entities served by smaller public accounting firms. Although these are the most significant segments by far, there are others in which the supply and demand segments overlap: for example, small businesses audited or reviewed by large CA firms.

The disparity between the two major segments above was amply illustrated by the reaction of public accounting firms and their clients to the recommendations of the Ontario Government Committee on Inflation Accounting released in June 1977. The committee recommended that the government of Ontario "take the initiative in establishing the practice of disclosure of the effects of inflation on business..." either by entreaty and leadership or by drafting regulations to The Ontario Securities Act after a one-year experimental implementation period. Irving L. Rosen, a prominent Ontario CA and past president of the ICAO, whose firm serves many small business clients, stated bluntly that inflation accounting would be too sophisticated and too costly for small businesses to adopt, unless it somehow reduced their tax burden[14]. He warned that if the "inflation-lobbyist accountants" wished to abolish historic cost accounting, small practitioners like himself might band together to resist them.[15]

Surprisingly, there is already a precedent in England for such dissention among chartered accountants. The English Institute

advocated compulsory inflation accounting recently. Two partners of a small CA firm proposed to the membership at large a resolution that inflation accounting be made not compulsory. At first, no one apparently took the resolution seriously. When it became apparent that the resolution had substantial support from small practitioners, the English Institute appealed to the membership that "the public standing of Chartered Accountants and of your Institute would be seriously damaged if the resolution were passed." Nevertheless, the resolution was passed.

I.L. Rosen goes on to castigate what he calls a particular CA triumvirate:

> "I am sure there are many who will disagree with me. In my opinion they can be divided into three categories, which, in no order of priority, are: the CA empire builders who feel they have discovered the best accounting practice, which must be imposed on business because it is obviously good for business; the CA valuators who will make a lot of money valuing assets and business (the art of valuation, however, leaves a great deal to be desired -- including the cost); and, the academics practising their mystic arts, who for the moment manage to come up with numerous and conflicting theories of inflation accounting, and not having to write voluminously on the subject indicating the courage of their confusions."

(The authors of this paper, presumably, belong in Mr. Rosen's third category). Although I.L. Rosen's views appear extreme, it is probably safe to conclude that there is considerable relevance in his analysis for the Professional Organizations Committee: rules for big firms are often not applicable to small ones. In his words, "there is no sense providing the patient with the finest medicine and having him die from shock at the cost."[16]

There is considerable evidence of the validity of our hypothesis on the demand side as well. A recent study by Touche Ross & Co. revealed that all but nine of Canada's 200 largest industrial companies are audited by one of the "Big 8" CA firms.[17] Only the large CA firms have the sophistication, expertise, and manpower to carry out these complex engagements.

To summarize, it is likely that in the large segment, markets are more efficient than in the small segment. On the other hand, the Philip Morris example points out that even in this segment accounting principles have some import. In the small segment, accounting principles probably have a much more direct impact on business decisions, because there is less other publicly available information for participants in the market to use. It is also likely that public accountants have considerable influence in the small segment by dint of the close consulting relationship that many of them have with their clients (see Chapter 2).

The next section of this chapter explores the various ways in which public accounting may affect economic behaviour.

II. EFFECTS OF PUBLIC ACCOUNTING ON ECONOMIC BEHAVIOUR

In this section we consider the demand for public accounting services and the potential effects of public accounting on economic behaviour.

II.(a) The Demand for Public Accounting Services

In Western countries various kinds of public accounting services are prescribed by statute. For example, companies incorporated under the Ontario Business Corporations Act must have an audit performed unless their revenues and assets amount to less than certain specified limits. However, there exist in the literature many persuasive arguments that indicate that there would be a significant demand for public accounting services even in the absence of such statutes. These arguments are discussed below in two categories: intuitive and theoretical.

1. Intuitive Arguments

Intuitive arguments for the existence of demand for public accounting services are conveniently summarized in A Statement of Basic Auditing Concepts[18]. The most compelling one seems to be that there is often a conflict of interest between the user and preparer of financial information. For example, management (preparer) would evidently like to show its firm in the best possible light when applying to a banker (user) or a shareholder (user) for capital. Users, then, require some validation of the information before they will rely on it. If preparers did not pay to have audits or reviews done, users would have to pay the costs of collecting what is now public accounting information. Moreover, the overall cost of obtaining information might be much higher, since each user would have to initiate a new study to suit his or her special information requirements.

Remoteness, caused by physical separation, may also give rise to demand for public accounting information. On one hand, shareholders of large firms are often widely dispersed. On the other hand, shareholders and creditors who have an interest in small firms may ot have the time or inclination to collect for themselves what is now public accounting information. Even if they have, they may not be able to interpret it or to assess its quality. The association of the name of a public accountant with financial information gives them some assurance that the items noted on the financial statements exist and that they have been accounted for according to an established set of accounting conventions.

Another intuitive reason for the demand for public accounting services is that in a complex information network there is always the possibility of errors, either intentional or unintentional. Audits and reviews may find these errors and encourage preparers not to make them.

2. Theoretical Arguments

The literature on signalling [19] and adverse selection [20] may be used to rationalize a demand for public accounting services. In a market where information is asymmetrically held, self-selection may occur by those offering securities for sale. For example, if securities of different quality were selling at the same price, below average securities might be offered in such quantity as to drive out above average securities. In such a situation, it would pay for above average securities to signal to the market

by paying for an audit: an action that would be irrational unless they were in fact of higher quality. Of course, once the above average securities had provided this signal, many below average securities would have to follow suit or else suffer even more by comparison.

Jensen and Meckling[21] feel that the economic theory of agency may explain the demand for audits. A divergence of interests between management and outside stockholders might make management willing to incur some monitoring costs (e.g. audit payments) if these could reduce agency costs.

Ng[22] and Gonedes[23] employ a capital market equilibrium model to analyze possible demands for audit services by market participants. Ng, in particular, derives some interesting theoretical conditions for auditing to lead to a Pareto-wise better resource allocation scheme.

From these arguments we conclude that in the absence of statutory requirements there would still be considerable demand for public accounting services. It is hard to speculate, however, about what form these services would take. We would suppose that in many cases less public accounting information would be demanded than that currently supplied by the profession -- particularly by small and medium-size businesses. In other instances, more would be demanded, depending on the current economic environment. For example, recently there seems to have been demand for more public

accounting information concerning illegal payments and fraud by large business corporations.

II.(b) Potential Effects of Public Accounting on Economic Behaviour

In Section I we considered two extreme hypotheses concerning the efficiency of capital markets and the reactions of users to public accounting information. The truth no doubt lies somewhere between the two and may be different in the different segments that we discussed. Whatever the strength of the effect, in this section we consider the various directions in which public accounting influences might be exerted. It is important to note before we begin that there does not exist at present a good positive theory of accounting, a theory which, as Jensen says, would explain "why accounting is what it is, why accountants do what they do and what effects these phenomena have on people and resource allocation."[24] What follows, to the best of our knowledge, is the best we can do at this time.

Prakash and Rappaport[25] identify three user groups on which public accounting standards may have a significant effect:

(i) Intended users, people to whom financial reports are primarily directed: for example shareholders of public corporations or bankers for small businesses.

(ii) Free riders, people for whom financial reports are not directly intended, but who have access to them because they are publicly available: for example, competitors, labour unions, suppliers, customers, government agencies, and special interest groups.

(iii) Preparers, who anticipate feedback from the groups noted above which may depend on the required measurement and disclosure standards. Prakash and Rappaport[26] use the term "information inductance" to refer to the complex process by which the behaviour of an information sender is influenced by the kind of information he must communicate.

To this list we add a fourth group.

(iv) The professionals themselves. Public accounting standards no doubt determine to some extent the kind of person who may wish to become a professional accountant and whether, on qualification, he wishes to remain in public practice. Important research is now in progress by Pollock, Amernic and Aranya of the Department of Political Economy, University of Toronto, which may be very illuminating in this regard.

We now discuss the potential impact of public accounting standards on these four groups in turn.

1. Intended Users

Audited or reviewed statements are signals generated by an information system. Their effect on intended users may be termed an information effect. The reaction of the users, in turn, may give rise to a production effect.

We have no doubt that public accounting affects both the expected

value and the risk of the preparing firm's future market value. For example, Ng's[27] four hypotheses are all combinations of increasing or decreasing expected value and risk. We know of no good theory to indicate the superiority of one hypothesis over the others. We suspect, however, that most public accountants believe that a routine audit in which no new adverse information comes to light will at least reduce the risk and leave expected value constant. Ng[28] considers this to be plausible because audits prevent managers from producing noisy signals. In an efficient market, however, audits may increase the uncertainty facing investors, since they cannot know in advance what an audit signal will be. Hirschliefer[29] and Ohlson[30] argue that information production generally increases the risk faced by investors, since the variability of security prices is larger in a finely, as opposed to coarsely, partitioned information environment (ignorance is bliss?).

The production effect follows from the information effect. Suppose, for example, that audits reduced the risk and increased the expected value of a firm's future value. Then investors would pay more for the firm's securities and the firm's cost of capital would be lower. Since firms select real investment projects by computing net present values using this cost of capital, real investment/consumption patterns in the economy may also be affected by public accounting standards. Another production effect, which is perhaps more logically discussed as an example of information inductance below, may be that audits act as a deterrent to fraud --

although public accountants are quick to point out that this is not a major role of auditing.

Another interesting theoretical conclusion of Ng[31] is that having a firm pay for its own audit reduces transaction costs involved in collective audit payments and that those who stand to benefit most from the audit, the shareholders, also pay for the audit. Ng has no empirical data to support this conclusion, however, and his equilibrum model is subject to Roll's[32] criticism discussed in Section I.

2. Free Riders

Publicly available accounting reports may affect the behaviour of free riders. Labour unions might use them in negotiations. An example occurred for the U.S. Steel Corporation in the 1950's. Labour claimed that the firm could well afford to increase wages; the firm argued that insufficient accounting depreciation, based on outdated historic costs, made profits appear to be artificially high. Regulatory bodies might use the reports for anti-trust regulation, rate regulation, or environmental protection regulation. Competitors, suppliers and customers may alter their strategies in dealing with the reporting entity because of financial accounting disclosures. Bond rating services, such as Moody's, or credit rating agencies, such as Dun & Bradstreet may interpret public accounting information in different ways, depending on the standards employed. Finally, the companies' financial accounting numbers serve as an essential data base for

the aggregate statistics that describe the state of the economy and, in turn, influence macroeconomic policy decisions by governments. A change in accounting standards would make time series analysis of such data very difficult.

Prakash and Rappaport[33] develop another very interesting hypothesis concerning free riders. Intended users, who would otherwise favour a change in public accounting standards to obtain more relevant information, may be averse to sharing the new information with free riders. In such a situation, they may actually wish less disclosure of relevant information. The costs and benefits of this disclosure decision are hard to determine, however, and Prakash and Rappaport have no empirical data with which to confront the theory.

3. Preparers of Public Accounting Information

Prakash and Rappaport[34] posit that economic actors are influenced by the type of information they are required to report as well as by the type of information they are provided. John C. Burton, former Chief Accountant of the Securities Exchange Commission states, "...there is no doubt that measurement standards have an impact on behaviour. The way you keep score determines in part the way you play the game." For example, corporate management, anticipating feedback from the behaviour of intended users and free riders, might choose to alter its own economic behaviour. Management's anticipations may or may not be rational in the sense described in Section I. In fact, they may be predicated on the

naive investor hypothesis as in the Philip Morris case. Nevertheless these anticipations may influence their resource allocation decisions and may result in real changes at the industry and economy levels.

Interestingly enough, there have even been decision models proposed in the literature that explicitly take these anticipations into account. Robichek, Ogilvie and Roach,[35] for example, start with the premise that accounting earnings per share is an important determinant of share price. They incorporate this statistic in a capital budgeting model using a constrained optimization technique in which management endeavours to maximize the net present value of the firm subject to a number of constraints, one of which is that next year's accounting earnings per share not be less than some number. In general this leads to a firm value lower than would obtain if the optimization were unconstrained by the accounting statistic, because some very attractive investment projects may not increase earnings per share for several years. If firms behave this way, it is obvious that accounting standards prescribing how earnings per share is measured and disclosed could have a non-trivial influence on the economy.

Prakash and Rappaport have termed this effect, "information inductance". Forbes[36] gives several additional examples. According to Forbes, the "pooling of interest (method) of accounting, which tends to inflate reported earnings after a merger, helped encourage the conglomerate craze of the late Sixties, and ...

changing those rules made conglomeration less attractive. This is only one example of how managements are frequently encouraged - or even forced - to make business decisions whose only purpose is to make the numbers look good".[37] Another example given by Forbes of the alleged influence of public accounting standards on economic behaviour of preparers does not fit into the information inductance category, but its effects may be very similar. FASB Statement 13 on accounting for leases proposed that corporations should capitalize lease assets and lease obligations so that their balance sheets could be compared with other corporations that had purchased the assets and financed them with debt obligations. During public hearings, the FASB was deluged by pleas from lessees that their bond indentures would be technically abrogated, should they be forced to show leases on thier balance sheets as liabilities (presumably the indentures constrained their accounting debt to equity ratios). As a result, the FASB relented and had to allow a four-year grace period for firms to change over. In general, there are many contracts, such as bond indentures, whose terms depend on accounting statistics. Accounting standards, then, no doubt constrain the behaviour of preparers through institutional and legal arrangements. These sorts of influences should be very much easier to determine empirically than those caused by pure information inductance.

4. The Profession Itself

It is likely that public accounting standards could influence the behaviour of practitioners. They could determine to some extent

the kind of person who wishes to become a public accountant and, once qualified, the kind of accountant who wishes to remain in public practice. For example, if accounting standards were rigidly prescribed by government, practitioners might be attracted who had little tolerance for ambiguity and who were averse to exercising professional judgment in solving clients' problems. If accounting standards affect economic behaviour, we must ask whether accountants' education, training, and psychological make-up adequately equip them to (a) assess the impact of accounting choice on resource allocation and (b) make the social choice implied by the measurement or disclosure standard adopted.

Controversy could well arise from disagreement on the potential economic impact of accounting choices. To resolve it we need professionals who are willing to build a good positive theory of accounting. However, controversy could also arise over the equity of the projected redistribution of wealth. In the absence (impossibility?) of a good normative theory of accounting, this sort of controversy may have to be resolved by government, but we need at least some professionals who are sensitive to the issues and who have some awareness of the concepts of Welfare Economics.

III. TECHNICAL COMPETENCE AND SOCIAL LEGITIMACY

Although we may never be able to describe fully the influence of public accounting standards on economic behaviour, it is probably safe to conclude that changes in standards governing disclosure and

measurement may give rise to a redistribution of wealth. Normally, one would expect governments to mediate conflicting values in our society. In the Western countries, however, governments have delegated accounting and auditing standard-setting to government agencies, such as the Ontario Securities Commission, or to professional bodies, such as the CICA or ICAO.

In the United States, a recent staff study prepared by the Senate Subcommittee on Reports, Accounting and Management (1976), chaired by Senator Lee Metcalf (usually referred to, in error, as "the Metcalf Report") recommended that the federal government take over accounting rule-making and audit standard-setting for publicly owned corporations. The report also demanded greater responsibility by CPA's for detecting and disclosing illegal acts by their clients. Forbes reaction was that "the whole report might have been written by William Jennings Bryan. Its old'fashioned populist premise is that businessmen are rogues and guilty until proven innocent".[38] Our assessment is that the staff study has been largely discredited by responses from the profession and from academe. Nevertheless, the study is important in that it has pointed out that there is a serious lack of understanding of public accounting by many groups in society and it has engendered a thorough re-examination by American accountants of their social and economic functions.

Forbes[39] reports some typical reactions to the staff study. Russel Palmer, managing partner of Touche Ross & Co., says, "...what really kills me is when you get these guys saying the Big 8

are too big. But when we're condemned because we missed some illegal payment in Milan...". Lee Seidler, deputy chairman of the Cohen Commission comments, "...believe it or not, some accountants say that they're not supposed to hunt for fraud. We think the auditor is kidding himself if he believes that. On the other hand, we think the public ought to realize that the auditor is not very good at finding it... People tend to think of auditors as detectives. They're not - they're accountants...Even if they look carefully, auditors will miss many, maybe even most, frauds".[40]

One of the main problems with the staff study approach, as we see it, is that there exists today no government agency with the training necessary to deal with complicated measurement and disclosure issues facing large public companies, nor with the experience or sensitivity to deal with the special accounting problems facing small businesses. On the other hand, the professional accounting bodies themselves do not have the social legitimacy to assess and resolve conflicts among competing interests. This may argue for government presence on the licensing body and at standard-setting discussions by the profession.

There are, we believe, dangers from too much government interference in the standard-setting process; aggregate corporate performance is a significant input to an analysis of government performance. If public accounting standards were formulated in the public sector, it is possible that they could be susceptible to political pressure. In particular, the administration in power may be

motivated by the desire to report good short-run performance. If so, there would certainly be many opportunities for governments to choose and prescribe accounting principles to accomplish this objective. The result, of course, would depend upon the validity of the rational expectations/efficient markets hypothesis.[41]

An example of public sector involvement in accounting rule-making is afforded by the 1971 investment tax credit controversy in the United States. The Accounting Principles Board (now defunct) of the AICPA stated that the benefit from the investment tax credit should be amortized (taken into income) gradually, over the life of the asset in question. Congress then countered with a <u>law</u> prohibiting CPA's from prescribing any particular accounting treatment for the credit, so that corporations could take the entire benefit into income in the current year if they wished. Although it is dangerous to ascribe motives to this law, it is certainly not inconsistent with a desire by government to give corporate profits, and aggregate economic performance, a quick boost.

It appears, then, that too much government involvement in public accounting standard-setting is undesirable. However, because of the conflict between technical competence and social legitimacy, some government involvement is unavoidable. In the total absence of government involvement, we envision petitions to governments nonetheless from parties who feel aggrieved by the welfare implications of accounting choices.

CONCLUSION

In view of the potential impact of public accounting on society, it appears that public accountants should develop and maintain competence in a number of areas. Certainly, it is not enough to be an expert accountant in the usual sense of the word. Public accountants should be well-educated, well-trained professionals with a good appreciation of the environment in which public accounting takes place and of the impact that accounting decisions might have on that environment.

FOOTNOTES TO CHAPTER 1

1. Ross M. Skinner, Accounting Principles: A Canadian Viewpoint, (Canadian Institute of Chartered Accountants, 1972), p. 367.

2. Rodney J. Anderson, External Audit Vol. I and II (Pitman, 1977).

3. John F. Muth, "Rational Expectations and the Theory of Price Movements", in Econometrica vol. 29 (July, 1961), pp. 315-335.

4. See Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work", Journal of Finance, vol. 25 (May 1970) pp. 383-417; and Eugene F. Fama, Foundations of Finance (New York: Basic Books Inc., 1976), especially chapter 5.

5. William Poole, "Rational Expectations in the Macro Model", Brookings Papers on Economic Activity 2 (1976).

6. Thomas J. Sargent and Neil Wallace, "Rational Expectations and the Theory of Economic Policy", Journal of Monetary Economics 2 (1976), pp. 168-183.

7. T.R. Dyckman, Efficient Capital Markets and Accounting, (prentice-Hall Inc., 1975).

8. Baruch Lev, Financial Statement Analysis: A New Approach, (Prentice-Hall, Inc. 1974).

9. See, for example, Arthur L. Thomas, "The Allocation Problem in Financial Accounting Theory", Studies in Accounting Research #3, (American Accounting Association, 1969); Arthur L. Thomas, "The Allocation Problem: Part Two", Studies in Accounting #9, (American Accounting Association, 1974). See also John F. Dewhurst, "Is Accounting Too Principled?", CA Magazine (July, 1976), pp. 44-49; and Leonard G. Eckel, "Can Financial Accounting Allocations Be Justified?", CA Magazine, (May, 1976), p. 49.

10. See Richard Roll, "A Critique of the Asset Pricing Theory's Tests: On Past and Potential Testability of the Theory", Journal of Financial Economics, vol. 4, no. 2 (May, 1977), pp. 129-176; see also Fama, op. cit. (1976), especially chapter 9.

11. Forbes Magazine, Why Pick on the Accountant? (March 15, 1977).

12. Prem Prakash and Alfred Rappaport, "Informational Interdependencies: System Structure Induced by Accounting Information", Accounting Review, (October, 1975), pp. 723-734.

13. See Prakash and Rappaport, op. cit. (1975). See also Prakash and Rappaport, "Information Inductance and Its Significance for Accounting", Accounting, Organizations and Society, vol. 2, no. 1 (Oxford, England: Pergamon Press, 1977).

14. Irving L. Rosen, "Inflation Accounting - A Fable", Check Mark, vol. 17, no. 1 (Institute of Chartered Accountants of Ontario, October, 1977), p. 1.

15. Ibid., p. 4.

16. Ibid., p. 4.

17. Susan Goldenberg, "When the Top 200 Want an Accountant, They Go to the Big 8", Financial Times of Canada, (November 21-27, 1977), p. 12.

18. American Accounting Association, A Statement of Basic Auditing Concepts, (1973).

19. See Michael Spence, "Job Market Signalling", Quarterly Journal of Economics 87 (August, 1973), pp. 355-374, and "Competitive and Optimal Responses to Signals: An Analysis of Efficiency and Distributions", Journal of Economic Theory 7 (March, 1974), pp. 296-332.

20. G.A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", Quarterly Journal of Economics 84 (August 1970), pp. 488-500.

21. M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", Working Paper, (University of Rochester, 1975).

22. See David S. Ng, "Capital Market Equilibrium, Value of External Auditing, and the Demand for External Audit Services", unpublished mimeograph, Standford University, (January 1976), and "Information Accuracy and Social Welfare Under Homogeneous Beliefs," Journal of Financial Economics 2 (March 1975), pp. 53-70.

23. Nicholas J. Gonedes, "Information Production and Capital Market Equilibrium", Journal of Finance 30 (June 1975), pp. 841-864.

24. Michael C. Jensen, "Reflections on the State of Accounting Research and the Regulation of Accounting", a paper presented at the Stanford Lectures in Accounting, May 21, 1976.

25. Prem Prakash and Alfred Rappaport, "Information Inductance and Its Significance for Accounting", op. cit. (1977) n. 13.

26. Ibid.

27. David S. Ng, "Capital Markets Equilibrium, Value of External Auditing, and the Demand for External Audit Services" mimeograph, Stanford University (January 1976).

28. Ibid.

29. Jack Hirschliefer, "The Private and Social Value of Information and the Reward to Inventive Activity", American Economic Review 61 (September 1971), pp. 561-574.

30. J. Ohlson, "On Financial Disclosure and the Behaviour of Security Prices", Working Paper, (University of California, Berkeley), 1975.

31. David S. Ng, op. cit., n. 27.

32. Richard Roll, "A Critique of the Asset Pricing Theory's Tests: On Past and Potential Testability of the Theory", Journal of Financial Economics vol. 4, no. 2 (May, 1977) pp. 129-176.

33. Prakash & Rappaport, op. cit. (1977), n. 13.

34. Ibid.

35. Alexander A. Robichek, Donald C. Ogilvie and John D.C. Roach, "Capital Budgeting: A Pragmatic Approach", Financial Executive (April 1969). Reprinted (abridged) in Anthony, Dearden and Vancil, Management Control Systems, Richard D. Irwin, Inc., 1972, pp. 747-753.

36. Forbes Magazine op.cit., (1977), no. 11.

37. Ibid.

38. Ibid.

39. Ibid.

40. American Institute of Certified Public Accountants, Commission on Auditors' Responsibilities, Manuel F. Cohen, Chairman, 1977.

41. For more discussion on public vs. private sector involvement in establishing accounting principles, see Horngren, 1972. Charles T. Horngren, "Accounting Principles: Private or Public Sector", Journal of Accountancy (May 1972) pp. 37-41.

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CHAPTER 2

THE ACCOUNTING PROFESSION IN ONTARIO - AN EMPIRICAL, ANALYTICAL AND INTUITIONAL DISCUSSION

In this chapter our principal concern is to provide a descriptive analysis of the structure of the accounting profession in Ontario so that we can assess the economic impacts of the current regulatory environment in the province and speculate intelligently on the possible effects of alternative regulatory arrangements. The principal structural features that are generally considered in a traditional industrial organization study are the degree of market imperfection on the supply side of the industry and the nature of existing and potential barriers to new entrants into the industry. Periodically, the structure of the market on the demand side is also considered.

A problem frequently encountered in industrial organization studies is defining the industry and demarcating its boundaries. One needs to calculate a series of cross-price elasticities of demand and set up some arbitrary criterion with regard to these elasticities in order to determine whether two products are close enough substitutes so as to be considered part of the same industry. The empirical problems encountered in estimating these cross-price elasticities are quite extensive and once one goes beyond a simple homogeneous product, the aggregation problems complicate considerably the difficulties encountered in such an exercise. Even if these empirical problems could be overcome, and at present they have not been overcome, there would still remain the problem of determining what value should be

used for the calculated elasticities, to separate industries.

For industrial organization studies of the tertiary sector of the economy, the problems faced by researchers are even more numerous. There is a need to define outputs for services before one can begin defining industry boundaries. National data collection agencies generally measure the output of professional services by the dollar value of inputs, labour and capital, that are used in providing the services. In effect, there is no objective and separate measure of output. The reasons for this should be quite obvious. If we take the case of the accounting profession, defining the output of professional accounting firms, whether they be licensed public accounting firms or non-licensed accounting firms, dramatically demonstrates the manifold problems implicit in this exercise. For example, when the question - what is the output of the accounting profession - was posed to members of accounting firms that were surveyed by members of the research team, the answers generally given were that the principal function and output of accounting was the lending of credibility to financial statements. Indeed the ICAO in their September, 1975 comment provided the same definition for the output of accounting, at least for the output of public accounting. While the auditing of a company's records or the undertaking of non-audit reviews of a company's financial records may in fact lend credibility to the financial information made available to interested parties, this still leaves a researcher with no concrete basis for

quantitatively measuring the output of this profession. What is a unit of credibility? Hence, this makes it extremely difficult to describe the structure of the industry and to assess the existing performance of this industry.

The degree of credibility, associated with various financial statements, resulting from the work of accountants is not a homogeneous product as perceived by users of the financial information and the "output" varies from user to user. This particular problem strikes at the heart of the issue of the need to regulate the accounting profession; namely, the necessity to ensure a minimum quality in the provision of the services of public accountants and thus a minimum degree of credibility of financial statements. However, without specific measurement of "output", one can speculate or perhaps try to develop some intuitive argument as to whether or not the degree of credibility that is added to financial statements from the provision of various types of accounting functions is excessive, adequate or insufficient, from an overall economic perspective, under the present regulatory regime; and whether the quantities would alter dramatically, if the regulatory regime were changed. Moreover, if it is determined that the present quantity of output were adequate and that under other various regulatory regimes the quantity of output would also be adequate, then the issue of regulation becomes one of cost. Is the appropriate quantity being provided at the lowest minimum social cost?

Given the measurement problems, it should be obvious that it is extremely difficult, if not impossible, to arrive at any definitive conclusion as to what should be the most appropriate form of regulation, if any, for this profession. The best we as researchers, can do, is try to develop a logical argument, supporting one view or another, based to some extent on a study of the industrial organization and behaviour of the industry.

Another problem that arises in studying the accounting profession stems from identifying the participants on the demand side of the market. The demand for intermediate goods and services is generally derived from the demand of the final products produced by the firms purchasing the intermediate inputs. However, this need not be the case for public accounting services - audits and non-audit reviews. As pointed out in Chapter one, demands for various kinds of public accounting services are necessitated by statute and hence are not associated with the attainment of a specific production or profit goal. In situations in which audits are not required by law, but firms purchase some type of public accounting service in order the provide lending institutions with information in support of loan requests, it can be debated whether or not the demand for public accounting services is a derived demand or artificially created by a third party. While it may be argued that the use of these funds enables the firm to

achieve certain production and profit objectives, the introduction of a third party (the lending institution) complicates the demand side of the market.

In most relevant cases, the business enterprise or individual contacting a lending institution is at a bargaining disadvantage vis-à-vis this institution.[1] Hence the business enterprise generally is not given a choice of paying a higher interest rate to compensate for the increased risk associated with a loan unsupported by an audited or reviewed financial statement; or being charged a lower rate to compensate the firm for the lower risk resulting from an audit or review of their financial records. It is conceivable that if such a choice were given to the business firm, the firm might select to pay the higher interest penalty since this would be a cost spread out over the time period of the loan and would not be a lump-sum cost incurred prior to obtaining the loan. Furthermore, given the possibility that the loan may not be approved and, secondly, that the lending rate may not actually contain an allowance for a lower risk associated with the loan, if there were a more competitive bargaining situation, it is extremely likely that in many cases the small business enterprise would select not to have an audit or non-audit review performed at its own expense. In addition, in many cases the accounting firm that is hired is recommended or selected by the lending institution. In other cases, the public accountant is selected by the business firm but approval by the lending

institution is generally required. Thus, one must question whether it is the lending institution or the business enterprise that is in fact demanding the public accounting service.

Thus we have two problems, at least at the public accounting end of the profession: (1) the concrete measurement of the output of public accounting firms is difficult to conceptualize both theoretically and empirically; and (2) the demand side of this market differs rather dramatically from the demand side of standard primary and secondary sector markets and from most other tertiary sector markets. The peculiarity of the demand side is important to keep in mind when assessing the need for and the effect of regulation of public accounting in this province. While these problems exist, however, the definition of industry boundaries is much more straightforward in this case than in the case of most other industries. The existence of regulation of the profession sets the boundary for the industry; namely, public accounting firms providing auditing and non-audit reviews. Yet there exist other services that are provided by accounting firms and in these other areas industry boundaries are somewhat more complicated to identify and, at the same time, the definition of output is equally cumbersome.

Among the other principal services provided by any public accounting firms and non-public accounting firms are management consulting services, corporate taxation services, bookkeeping services, electronic data processing services, personal

taxation and estate planning services. These various services have one feature in common -- they are of a consultative or advice- giving nature. Unlike public accounting services in which the demand can originate with third parties or because of public statutes, these consultative services are demanded directly by second parties and for the explicit purpose of improving the functioning of the firm and the attainment of profit objectives. This distinction between public accounting services and non-public accounting services is important when analyzing the effect of the current and alternative regulatory regimes. For example, as alluded to in Chapter one, distinctions on the demand side point to a rather important market segmentation in the accounting "industry". Moreover, later in this chapter we will consider the inter-relationship on the demand side between the demand for public accounting services and the decisions on the part of second parties to demand other non-public accounting services from public accounting firms. To preview to some extent part of this discussion, we have discovered that there tends to be a spillover or spinoff for most public accounting firms when a client comes to them to purchase a public accounting service. That is, the clients generally decide or are advised to purchase other non-public accounting services as well from the same firm. This type of behaviour establishes or creates an important constraint on the search process of firms requiring non-public accounting services and thus, while it may be argued that the current regulation of accounting in this province only impinges on the performance of the adding of

credibility to financial statements part of the profession, it also has an impact on the structure of the non-regulated part of the industry.

It is important to recapitulate at this time the principal problems that must be considered when assessing the appropriate form of regulation of the accounting profession:

1. The inability to measure objectively, in quantitative terms, the output of public accounting creates problems for evaluating the effects of different regulatory regimes on the link between the output and structure of the accounting industry and the overall performance of the economy, particularly, the growth, inflation, unemployment, income distribution and balance of payments aspects of performance.

2. Although there appears to be a distinct segmentation of the accounting industry, along the lines of public accounting services and non-public accounting services, it is important to keep in mind the interrelationships between the two segments resulting from the interaction between clients and public accounting firms. Moreover, it will be important to consider other forms of segmentation that occur in the

accounting profession, particularly in the public accounting segment of the industry. For if it can be established that on the demand side, as well as on the supply side, of the public accounting "industry" there exist distinct identifiable segments, each one encountering different problems and resolving them in different manners, then it will be necessary to analyze the impact of different regulatory regimes within a context of industry segmentation.

3. The inability to measure output presents a problem in comparing price-quantity - quality differences among public accounting firms and non-public accounting firms. This brings into question the usual *raison d'être* of industrial organization studies; namely, the assessment of the efficiency of the functioning of a particular industry.[2]

With these considerations in mind we will now proceed to describe the structure of the industry in the following sections of this chapter. The description of the structure of the accounting profession will constitute Section I. The primary data source for this section is the survey of accounting firms in the province.

The survey was sent to all public accounting firms in the province, both CA and CGA firms that were licensed to perform public accounting services. Of the 1758 firms to which surveys were sent, approximately 890 returned the surveys, although in most cases the number of usable results was lower.

In the second section of this chapter, we will examine the demand/supply interaction and focus on the search process of clients of accounting firms. The primary sources of information for this section are the survey of clients (second party clients of accounting firms) and results of personal interviews with accounting firms and key third party users of financial information. The survey of clients, while not as comprehensive as that of the survey of accounting firms, nevertheless, provided results that were consistent with the views presented by accountants, and third party users.[3]

In Section III of this chapter, we will focus on the price and quality aspects of the accounting industry. We will consider the importance of price from the point of view of users of accounting services, and the determination of prices for various services. In addition, we will examine the perceived relation between price and quality. The primary sources of information for this section are the accounting firm survey, the clients survey, and the personal interviews with accounting firms.

Section I: Industry Structure

As of February 1978 there were 3535 public accounting firms operating in the province of Ontario. There were 5678 CA's and 71 CGA's, and 389 other licensees in these firms. Of the 1758 questionnaires sent out in 1977, there were 629 usable responses in which one or more of the principals in the accounting firms were CA's, 58 in which the principals were CGA's, two in which the principals were RIA's with no other accounting designation (to preserve anonymity, these responses will not be reported), and 123 in which the principals had no CA, CGA, or RIA designation (this category includes firms with APA principals). For purposes of the discussion in this section, we have broken down CA firm respondents into different size categories - firms with 1 CA, firms with 2 CA's, firms with 3 CA's, firms with 4 or 5 CA's, firms with 6 to 10 CA's, firms with 11 to 25 CA's, firms with 26 to 150 CA's, and firms with 151 or more CA's. All of the CA's in a particular firm did not need to be partners in that firm.[4] The CGA firms were not similarly disaggregated because only 8 firms had more than one CGA and the largest two had only 3 CGA's. As noted below, manpower data for the other non-CA firms were difficult to interpret, and hence they have been excluded from cross-tabulations and regressions involving manpower data.

Of the CA firm respondents, 58% (363) were firms with only one CA. Another 25% of the firms had either 2 (99 firms) or 3 (56 firms) CA's. At the other extreme, just over 1% of the respondents were firms with 26 or more CA's (see Table 1). In terms of relative size, the respondents varied from firms with 1 CA to the largest firms with an average of 261 CA's (see Table 1). In terms of total number of accountants, students

Table 1

Selected Manpower and Geographic Characteristics of C.A. Firms of Different Size

		Number of C.A.s in firm							
	Characteristics	1	2	3	4-5	6-10	11-25	26-150	151+
1.	Average no. of CAs per firm	1.0	2.0	3.0	4.4	7.8	14.9	78.2	260.6
2.	Total no. of CAs	374	204	168	257	225	239	313	1,303
3.	Portion of all CAs	12.1%	6.6	5.4	8.3	7.3	7.8	10.2	42.3
4.	Average no. of CGAs and RIAs per firm	0.1	0.1	0.3	0.2	0.4	0.2	3.3	0.6
5.	Total no. of CGAs and RIAs	27	11	20	11	11	3	13	3
6.	Average no. of students per firm	0.1	0.6	1.5	3.3	5.5	13.8	93.5	224.4
		(1.2)[1]	(2.0)	(2.6)	(3.8)	(5.9)	(13.8)	(93.5)	(224.4)
7.	Total number of students	48	59	82	192	157	220	374	1,122

Table 1 (continued)

		1	2	3	4-5	6-10	11-25	26-150	151+
8.	Proportion of all students	2.1%	2.6	3.6	8.5	7.0	9.8	16.6	49.8
9.	Average no. of group E Employees per firm [2]	0.4	1.4	0.9	1.9	2.9	3.2	34.8	14.6
10.	Total no. of group E employees	152	138	48	112	85	52	139	73
11.	Average no. of group F employees per firm [3]	0.1	0.1	0.2	0.2	0.2	0.4	0.8	0.4
12.	Total no. of group F employees	22	10	14	9	5	7	3	2
13.	Average no. of non-CAs per CA	0.7	1.2	1.0	1.2	1.2	1.2	1.7	0.9
14.	Average no. of persons per firm	1.7	4.3	6.0	9.9	16.9	32.8	211.0	500.6
15.	Total no. of persons	625	419	337	582	491	524	844	2503
16.	Proportion of all persons	9.9%	6.6	5.3	9.2	7.8	8.3	13.3	39.6

Table 1 (Continued)

		1	2	3	4-5	6-10	11-25	26-150	151+
17.	Number of firms by postal code								
	K	43	12	5	2	5	2	0	0
	L	78	15	12	7	4	1	0	0
	M	170	49	27	29	10	10	4	5
	N	51	15	8	16	7	3	0	0
	P	21	8	4	3	3	0	0	0
18.	Proportion of firms by postal code								
	K	12%	12	9	4	17	13	0	0
	L	21	15	21	12	14	6	0	0
	M	47	50	48	51	34	63	100	100
	N	14	15	14	28	24	19	0	0
	P	6	8	7	5	10	0	0	0

Notes:

1. - Number of students per CA in firms that have students.
2. - Employees who do not hold accounting designation, who have never been official students in an accounting program, but who assist in providing services to clients - excluding secretaries and clerks.
3. - Employees who have attempted but failed to attain an accounting designation (once and for all) - excluding clerks.

and paraprofessionals, the size of the firms ranged from an average of 1.7 persons per firm for the smallest firm category, to just over an average of 500 persons per firm in the largest firm category. The 629 respondents employed 3,083 CA's, 83 CGA's, 27 RIA's, 2,254 students, and 871 paraprofessionals of varying qualifications (see Table 1). Of the 3,083 CA's, 746 or 24% of them were employed in firms with one, two or three CA's.[5]

Of the respondents, 1,303 or just over 42% were employed by firms in the largest firm category (that is, firms with 151 or more CA's). Most of the CA public accounting firms did not employ CGA's or RIA's. As for students, there were an average of 0.1 students per firm in the smallest firm category (1.2 per firm in this category in firms that did employ students) and 224.4 students per firm in the largest firm category. For paraprofessionals with no previous accounting experience, the numbers ranged from 0.4 per firm in the smallest firm category to an average of 34.8 paraprofessionals per firm in the second largest firm size category. In the largest firm category, the number of paraprofessionals per firm averaged 14.6

As for the geographic location of the firms, about 304 or 48% of the respondents had their head offices situated in the Metropolitan Toronto area. Another 117 or 19% had their head offices situated in the key suburban fringes of Metropolitan Toronto. Sixty-nine or 11% of the firms had head offices situated in eastern Ontario, particularly around Ottawa; 100 firms were in south-western Ontario and only 39 or 6% had head offices in northern Ontario.

The 58 CGA firm respondents ranged in size between one and three CGA's and an average of 1.3 and 10.5 total employees (see Table 2). The one-CGA firms did not use students while the two three-CGA firms employed a combined total of 7 students. The CGA firms responding to the survey were one-office firms distributed more evenly across the province than were the one- or two-CA firms.

Turning our attention to Table 3 in which we have listed the proportion of gross fees accounted for by different service categories, we find, not surprisingly, that for all size categories among the CA firms public accounting services (auditing, non-audit reviews and non-audit, non-reviews) accounted for the majority of the gross fees earned by CA firms. With a minor exception, (the second and third largest firm categories), the proportion of gross fees earned from public accounting services rose in line with the size of the firm, from a low of 50.1% for firms with only one CA to just over 77% for firms with over 151 CA's. In line with this positive correlation between the proportion of gross fees earned from public accounting and size of CA firm, there is a similar positive correlation between the proportion of gross fees earned from auditing and size of firm. Indeed, this correlation is even more dramatic than that for all public accounting services. In the case of the smallest CA firms, auditing accounted for an average of 19.4% of the gross fees; whereas for the largest CA firms, auditing accounted for just under 72% of all gross fees.

Table 2

Selected Manpower and Geographic Characteristics of non-CA Public Accounting Firms of Different Size

Characteristics	Number of CGA's in Firm 1	2	3	Other non-CA firms
1. Total no. of CGA's	50	12	6	N/A[4]
2. Average no. of students per firm	0.0 (0.0)[1]	1.2 (1.2)	3.5 (3.5)	N/A
3. Total number of students	0	7	7	N/A
4. Average no. of group E employees[2]	0.3	2.8	4.0	N/A
5. Total no. of group E employees	15	17	8	N/A
6. Average no. of group F employees[3]	0.0	0.0	0.0	N/A
7. Total no. of group F employees	0	0	0	N/A
8. Average no. of non-CGA's, CA's per CGA	0.3	2.0	2.5	N/A
9. Average no. of persons per firm	1.3	6.0	10.5	N/A
10. Number of firms by postal code				
K		8		13
L		15		19
M		15		49
N		12		24
P		7		9

Notes:

See Table 1

4 - Manpower data for these firms is difficult to interpret. See footnote 8 at end of chapter.

Table 3

Percentage of Gross Fees Earned by CA Firms
of Different Size, and CGA Firms, by Service Categories

		Number of CAs in firm								CGA firms	Other*
	Service category	1	2	3	4-5	6-10	11-25	26-150	151+		
1.	Auditing	19.4%	26.0	32.5	38.1	39.2	49.3	52.4	71.6	10.5	21.8
2.	Other Public Accounting	30.7	31.9	30.0	25.8	25.7	20.8	13.3	5.6	27.2	30.3
3.	Total Public Accounting	50.1	57.9	62.5	63.9	64.9	70.1	65.7	77.2	37.7	52.1
4.	Corporate Taxation	7.6	8.4	7.8	7.9	6.9	7.6	9.5	8.8	6.7	5.0
5.	Management Advisory Services	9.4	5.3	7.2	5.2	6.6	4.3	8.0	0.8	9.4	4.2
6.	Book-Keeping	17.2	13.1	9.2	8.8	7.0	7.3	6.3	1.0	27.6	25.7
7.	Personal Taxation/ Estate Planning	12.0	11.2	10.9	8.1	9.1	5.4	4.0	2.4	16.6	9.7

* Firms in which principals do not have CA, or CGA designation (includes APA firms).

Note: Column percentages do not sum to 100%, due to the exclusion of a "miscellaneous" service category.

While larger firms specialize more in auditing, the smaller firms specialize more in other public accounting services. In this case, we find almost an inverse correlation between the proportion of gross fees earned and size of firm, with the smallest firms earning about 31% of their gross fees from other public accounting and the largest firm group earning just under 6%. These results suggest that there does exist segmentation on the supply side of the public accounting industry - the large firms concentrating their efforts on auditing and the smaller firms dividing their time and efforts on both auditing and other public accounting. This initial evidence of market segmentation is important, particularly as it will relate to the whole issue of regulation, quality standards, and client perception of service quality.

The proportion of gross revenues earned from the provision of corporate taxation services tended to be roughly equal across CA firms of different size, ranging from a low of 6.9% for CA firms with between 6 and 10 CA's per firm and 9.5% for CA firms with between 26 and 150 CA's. In the management advisory service component, the proportion of fees ranged from 4.3% to 9.4% if we exclude the five largest firms. The five largest firms established separate management consulting companies and these services were provided basically through these incorporated subsidiaries.

Three other observations in Table 3 are worth commenting upon. First of all, there is the rather high proportion of gross fees

earned from the provision of bookkeeping services by the smallest CA firms (namely, those with one, two or three CA's per firm) and particularly by the CGA and other non-CA firms. The dependence of these small public accounting firms on bookkeeping raises a question about the degree of independence between a client and the accountant in such firms. As became apparent to us from our interviews with accounting firms, accountants in one- or two-man firms viewed their clients to be the firms for whom the service is directly provided, not third party users of the financial information. In these cases, the accountants viewed their primary role as a financial advisor to small businessmen. Another question that arises is whether or not a large number of the accountants in public practice who are highly dependent upon bookkeeping as a source of revenue do in fact keep up with the most current principles in auditing and non-audit reviews.

Secondly, there appears to be an inverse correlation between the proportion of fees derived from personal taxation and estate planning and the size of public accounting firm. Personal taxation and estate planning services contributed about 12% of the total gross fees for the smallest CA firms and 16.6% for the CGA firms, while for the five largest firms, such services contributed just about 2.4%.

Thirdly, the CGA and other non-CA firms appear to be similar to the one-CA firm in terms of the distribution of their fees by service category. The CGA firms receive somewhat less of their fees from the provision of public accounting services and somewhat more from bookkeeping and personal taxation.

The data in Table 4 supplement those in Table 3. They indicate that a rather large number of one-man CA and CGA public accounting firms do not do any auditing or other public accounting. In the case of auditing, there are 78 one-CA firms out of a total of 336 that do not do any auditing whatsoever; whereas for other public accounting, there are 62 such firms. Altogether, there are 24 firms (7.4% of all one-man CA firms) that do not do any public accounting. The problem is proportionately greater among non-CA firms. As for the CGA firms, 31 out of 54 do no auditing, 13 do no other public accounting and 11 in total do no public accounting work at all. Of the 113 other non-CA firms, 32 do no auditing, 33 do no non-audit public accounting, and 13 do no public accounting at all. These observations raise a question about the minimum quality standards that are supposedly guaranteed by the current regulatory regime. Another point worth noting is that, despite the claims of many CA's that their primary role is that of a financial advisor there are a large number of CA firms that do not earn any fees from the provision of management advisory services. In the case of one-CA firms, 178 or 53% of the respondents do not appear to do any management advisory work. In the case of two-CA firms, about 44% of the respondents do no such work and even in the case of larger firms, those with 11 to 25 CA's, 6 out of 16 of the respondents receive none of their fees from the provision of management advisory services.[6] Nearly half of the CGA firms (25 out of 54) appear to provide no management advisory services.

Table 4

Number of CA Firms by size, and CGA Firms, that receive zero percent of their gross fees, or fifty percent or more of their gross fees from various service categories

	Number of CAs in firm								CGA firms	Other
Service category	1	2	3	4-5	6-10	11-25	26-150	151+		
Auditing - A	78	2	0	1	1	0	0	0	31	32
- B	11	1	1	3	2	1	0	2	3	20
Other Public Accounting - A	62	7	2	2	1	1	1	1	13	33
- B	22	4	0	0	0	1	0	0	10	30
Total Public Accounting - A	24	1	0	1	0	0	0	0	11	13
- B	64	20	15	15	6	7	0	3	16	62
Corporate Taxation - A	112	11	6	7	3	4	0	0	20	65
- B	1	0	0	0	0	0	0	0	0	1
Management Advisory - A	178	42	11	21	6	6	1	3	25	82
Services - B	16	1	0	0	0	0	0	0	3	2
Book-Keeping - A	85	15	9	8	3	3	1	1	8	32
- B	8	2	0	0	0	0	0	0	9	23
Personal Taxation/ - A	91	10	4	4	1	3	0	0	10	54
Estate Planning - B	3	0	0	0	0	0	0	0	3	4
Total number of firms	336	96	55	56	29	16	4	5	54	113

Notes: A - Zero percent of fees received in this service category
B - Fifty percent or more of gross fees received in this service category

It is possible that in performing non-audit reviews or undertaking audits or providing taxation advice, CA's, particularly those in smaller firms and CGA's who are more likely to be in regular contact with their clients, perceive that they are serving the role as a financial advisor even though they are not providing explicit management consulting services.

In Table 5, we present weighted average proportions of fees earned from a selected sample of public accounting and non-public accounting services by the CA's responding to the survey. The proportion of fees earned in the various services by each of the respondents was weighted by the number of CA's in the firms. What we observe is that public accounting firms are highly dependent upon public accounting as a source of revenue. Given the much higher weights for the largest firms, firms that specialize in auditing, it is not surprising that 51.3% of the gross fees of all accounting firms were derived from provision of auditing services. Another 16.9% of gross fees were earned from the provision of other public accounting services. The exclusion, by the present regulatory regime, of other groups from the provision of these services must be an important factor associated with the high degree of specialization by public accounting firms in the area.

TABLE 5

Weighted Average Distribution of Gross Fees for All C.A. Firms by Selected Service Categories

1.	Auditing	51.3%
2.	Other Public Accounting	16.9
3.	Total Public Accounting	62.8
4.	Corporate Taxation	8.3
5.	Bookkeeping	6.3
6.	Personal Taxation/ Estate Planning	4.9

In order to further examine the relationships between the proportion of fees earned from the various services and the size of firms and other selected variables, we estimated a number of straightforward relations using the ordinary least squares regression technique in the SPSS package. The results are reported in Table 6.[7] The list of regressors (independent variables) used in the empirical analysis included a constant, the number of CA's or CGA's in the firm, the proportion of gross fees earned from business enterprises with sales of between \$0 and \$1,000,000, the proportion of gross fees earned from business enterprises with sales of \$25,000,000 or more, a postal code dummy, an international affiliate dummy, and a CA-CGA firm dummy.[8] Since the number of CA's or CGA's is highly correlated with the proportion of fees earned from large business enterprises, (the correlation co-efficient between these two variables was 0.55), some peculiar signs appear for the co-efficients on either of these variables as a result of the problem of multi-collinearity.

Nevertheless, in most cases the signs on the co-efficients that we obtained appear to be reasonable and consistent with a priori expectations. For example, we find that the proportion of fees earned from auditing increases with the number of CA's/CGA's in the firm. A simple translation of the results suggests that for

Table 6

Multivariable Regression Results Using Percentage of Fees Earned by Service Category as Dependent Variables

Dependent Variables	Independent Variables							Selected Statistics				
	Constant	ACC7	POSTDUM	AFFINT	DMX	PCFEEBU1	PCFEEBU3	$\bar{R}^2$	F	SEE	Mean	NOBS
PCFEEAUD	30.38	0.168 (4.32)	4.17 (2.37)	-6.85 (-2.70)	13.26 (4.56)	-0.194 (-5.19)	-0.352 (-2.45)	0.14	17.30	20.08	24.5	578
PCFEEACC	-0.66	-0.108 (-2.63)	-1.50 (-0.81)	8.04 (3.01)	4.12 (1.35)	0.255 (6.49)	0.693 (4.57)	0.10	11.82	21.14	29.2	578
PCFEETAX	4.73	0.009 (0.63)	1.73 (2.60)	-1.19 (-1.24)	1.02 (0.93)	0.031 (2.18)	-0.050 (-0.93)	0.02	2.70	7.59	7.9	578
PCFEEBKK	16.76	-0.008 (-0.25)	-2.87 (-2.06)	-0.11 (-0.05)	-12.77 (-5.54)	0.163 (5.50)	-0.087 (-0.76)	0.11	13.33	15.92	15.1	578
PCFEEPER	21.24	-0.032 (-1.38)	-3.34 (-3.17)	0.06 (0.04)	-4.97 (-2.86)	-0.038 (-1.72)	-0.056 (-0.65)	0.03	4.48	12.02	11.6	578

Definitions:

PCFEEAUD - Percentage of fees from auditing.
PCFEEACC - Percentage of fees from other public accounting.
PCFEETAX - Percentage of fees from corporate taxation.
PCFEEBKK - Percentage of fees from bookkeeping.
PCFEEPER - Percentage of fees from personal taxation/estate planning.
ACC7 - Number of CA's in a firm in a CA firm or CGA's in a CGA firm.
PCFEEBU1-- Percentage of fees from businesses with sales of \$0-\$1 million.
PCFEEBU3 - Percentage of fees from businesses with sales of \$25 million+.
POSTDUM - Postal code dummy, 1 if L or M, otherwise 0.
AFFINT - International affiliation dummy, 1 if no international affiliates, otherwise 0.
DMX - Accounting firm dummy, 1 if CA firm, 0 if CGA firm.

Means:

ACC7	4.81
PCFEEBU1	74.10
PCFEEBU3	1.11
POSTDUM	0.65
AFFINT	0.98
DMX	0.91

each additional ten accountants in the firm the proportion of fees received from auditing rises by about 1.7 percentage points. The co-efficient value of .168 in that equation most likely over-estimates the impact on the proportion of fees from auditing resulting from an additional CA/CGA.[9] But, it is most likely, when proper allowance is made for the overestimate, that the impact of ten additional CA's in a firm is to increase the proportion of fees received from auditing by between 1 and 1.5 percentage points.

For the other service categories, as the number of CA's/CGA's in a firm increases, the proportion of fees earned from other public accounting declines - the relationship being a decline of 1.1 percentage points for every ten additional accountants. With regards to corporate taxation, there is no statistically significant relationship between the proportion of fees earned from the provision of services and the size of the firm as measured by the number of CA's or CGA's in the firm. With the other two service categories -- bookkeeping and personal taxation and estate planning -- although there is a negative relationship between the proportion of fees earned from these services and the size of the firm, once more, the co-efficients are statistically insignificant from zero.

The co-efficient values for the proportion of fees earned from small business enterprise variables are plausible. For example, the proportion of fees earned from auditing decline in line with the proportion of fees earned from small business enterprises. This implies that the demand for public accounting services originating from small business enterprises is not for auditing services but for non-audit reviews. In line with this observation, we find that the proportion of fees earned in the provision of other public accounting services increases with the proportion of fees earned from small business enterprises. As an example, we find, using the results in Table 6, that if the proportion of fees earned from small businesses with total worldwide sales of less than $1,000,000 increases by 10 percentage points, the proportion of fees earned from other public accounting will rise by about 2.6 percentage points.[10]

The other results for the proportion of fees earned from small business variables suggest a positive correlation with the proportion of fees earned from corporate taxation. Thus, small firms do appear to require the services of public accountants in preparing their tax records and tax statements. (This would be consistent with a standard production model in which the services of a professional body, in this case, public accountants, is demanded in order to achieve an after-tax profit objective.) Finally, many small business firms seem to demand bookkeeping services and thus we find a statistically significant positive relationship between the proportion of fees earned from the pro-

vision of bookkeeping services and the proportion of fees earned from small business enterprises.

The results for the variable - the proportion of fees earned from large business enterprises - are ambiguous and, as pointed out above, this results primarily from the collinearity between this variable and the ACC 7 variable. As for the postal code dummy variable - the variable has a value of 1 if the public accounting firm had its primary office in Metropolitan Toronto or the suburban fringe and a value of 0 if the primary office was located elsewhere in Ontario - we find, as expected, that those firms with their head offices situated in Metropolitan Toronto or the suburban fringe earn a larger proportion of their fees from auditing in comparison to those firms located elsewhere in the province. Indeed, accepting the co-efficients at face value, we find that firms with head offices in Toronto or suburban areas (postal codes L or M) received about 4.2 percentage points more in fees from auditing than did other firms. The Toronto-based firms also received about 1.7 percentage points more of their fees from the provision of corporate taxation services; about 2.9 percentage points less of their fees from the provision of bookkeeping services and 3.3 percentage points less of their fees from the provision of personal taxation or estate planning services than did firms based elsewhere in the province. This would suggest that the firms based in the Toronto area are more dependent upon auditing and corporate taxation than firms based elsewhere in the province. It appears that in

smaller urban areas and in rural areas of the province, public accounting firms with their head offices situated there serve more of a role of providing accounting services to private individuals and basic data manipulation for small business enterprises.[11]

With the international affiliate variable, we find for those firms that do not have any international affiliates that they receive 6.9 percentage points less of their fees from auditing than do the small number of firms with international affiliates. But, on the other hand, they receive 8.0 percentage points more of their fees from the provision of other public accounting services.

Finally, the co-efficients on the CA-CGA firm dummy revealed that, *ceteris paribus*, CA firms are more specialized in public accounting work than CGA firms and CGA firms are more specialized in providing bookkeeping and personal taxation services. For example, CA firms receive, on average 13.3 per cent more of their fees from auditing and 4.1 per cent more from other public accounting work. On the other hand, CGA firms earn 12.8 per cent and 5.0 per cent more of their fees from bookkeeping and personal taxation work respectively.

We can summarize the results presented in Tables 3 to 6, as follows:

1. There appears to be segmentation on the supply side in terms of the provision of auditing services and other

public accounting services. The larger public accounting firms specialize in the provision of auditing services, while smaller public accounting firms are more dependent on other public accounting services.

2. Other public accounting services such as non-audit reviews and non-audit, non-reviews are the services most demanded by small business clients, whereas auditing services are more likely to be demanded by the large business enterprise clients.

3. Small firms do not seem to specialize in the provision of management advisory services, and a large number do not provide any such services. Moreover, small business clients appear less likely to demand management advisory services than other business clients.

4. Small business clients tend to rely on public accounting firms not only for the provision of non-audit reviews, but also for taxation advice and bookkeeping services.

5. Public accounting firms with head offices outside the Metropolitan Toronto area tend to rely more on individuals and small business firms as the main users

> of their services. These public accounting firms are more likely to fulfill the role of financial and personal advisors in comparison to those firms with head offices in the Metropolitan Toronto area.[12]

In Table 7, we turn our attention to the proportion of fees earned from different client groups. Thus, instead of focusing on what type of services are being demanded, we are now looking at the main participants on the demand side, those directly purchasing the services of public accounting firms. Business enterprises constitute by far the largest market for accounting services. Between 86.5% and 92.6% of all of the gross fees of public accounting firms are earned from the provision of services to business enterprises. As expected, there is a dramatic inverse correlation between the proportion of fees earned from small business enterprises, those with total world-wide sales of less than $1,000,000 and the size of the public accounting firm. The small CA firms, those with one, two or three CA's in the firm, and the non-CA firms are highly dependent upon small business enterprises as their clients. For example, for sole CA proprietorships, an average of 76.6% of the gross fees are earned from small business clients, while for the CGA firms the average is 78.1%, and for other non-CA firms it is 75.3.
On the other hand, for the largest CA firms, particularly the big five in our sample, small business enterprises generated just under 20% of the total gross fees of these firms. With the middle group of business enterprises, those with total worldwide sales of between $1,000,000 and $25,000,000, there appears to be

Table 7

Percentage of Gross Fees Earned by
CA Firms of Different size, and CGA Firms, by Client Groups

	Number of CAs per firm								CGA firms	Other
Client group	1	2	3	4-5	6-10	11-25	26-150	151+		
Businesses with total world-wide sales of (1) $0 - $1,000,000	76.6%	76.0	71.9	67.6	68.8	64.6	41.3	19.6	78.1	75.3
(2) $1,000,001 - $25,000,000	9.7	13.3	17.4	22.4	19.0	21.9	34.0	30.8	7.5	7.7
(3) $25,000,001 +	0.9	0.2	0.0	1.3	0.9	2.6	13.0	42.2	0.9	0.0
All Businesses	87.2	89.5	89.3	91.3	88.7	89.1	88.3	92.6	86.5	83.0
Federal government	0.4	0.1	0.2	0.1	0.7	0.2	0.0	1.2	0.0	N/A
Provincial government	0.1	0.2	0.6	1.1	0.1	0.6	1.0	0.2	0.1	N/A
Local government	0.8	2.2	1.4	1.0	4.6	3.1	0.3	1.4	0.5	N/A
Individuals	8.7	6.2	5.6	4.8	4.7	3.7	8.3	2.0	11.5	10.1
Non-profit institutions	2.8	1.9	2.8	1.6	1.2	3.3	2.0	2.6	1.3	N/A

a positive correlation between the proportion of fees earned from such business firms and the size of the accounting firm, although the correlation is not that strong. Nevertheless, the proportion does rise from just under 10% for CA sole proprietorships and non-CA firms to between 31% and 34% for the largest two groups of public accounting firms. As for the largest group of business firms, those with total world-wide sales in excess of $25,000,000, we find that for accounting firms with less than 11 public accountants, such clients generate a rather small proportion, if any, of the total gross fees of public accounting firms. Even for public accounting firms with between 11 and 25 CA's, the proportion of fees earned from these large business clients amounts to just 2.6% on average. However, for the big five public accounting firms, large clients generate 42.2% of the total fees.

Thus, while we have already appeared to observe segmentation in terms of the type of accounting services demanded of accounting firms of different size, here we appear to observe segmentation in terms of the demand for accounting services from accounting firms of different size by business firms of different size. That is, while small business firms will tend to deal with accounting firms of all sizes, the large business firms appear to deal only with the largest CA firms. These results are consistent with the findings of the Metcalfe Report in the U.S. and a recent article in the Financial Times of Canada which pointed out that most of the 200 largest corporations in Canada use the big eight public accounting firms in Canada. Obviously, in this

spectrum of the accounting market, it may be fair to conclude that only the largest public accounting firms effectively function on the supply side. In the remainder of the market, all public accounting firms appear to be in competition with one another.

With the exception of the peculiar results for the public accounting firms in the category 26 to 150 CA's, the inverse relationship between the proportion of fees earned from individuals and the size of the public accounting firm is consistent with the findings reported in Table 3 of the inverse correlation between the proportion of fees earned from the provision of personal taxation and estate planning services and the size of the firm. Moreover, it is interesting to note that for CA public accounting firms with between 6 and 10 CA's in the firm, that 4.6% of the fees earned by such firms come from work performed for local governments. If we look back to Table 1, we see that this same group of accounting firms appears to be more equally spaced across Ontario, at least as regards head office location, and thus it is possible that such firms are the largest ones operating in many small urban centres and rural areas, and so are most likely to be approached by local governments for providing auditing or other public accounting services.

In Table 8, we find for the two smallest CA public accounting firm categories, (those with either one or two CA's per firm) and for the non-CA firms, that over 50% of the respondents earned 50% or more of their fees from small business enterprises (in the case of sole CA proprietorships 223 or roughly 70% of the respondents

Table 8

Number of CA Firms, by Size, and CGA Firms, that receive Zero Percent of their Gross Fees, or Fifty Percent or More of Their Gross Fees From Business Clients of Varying Size or From Individuals

	Number of CAs in firm								CGA firms	Other
Client group	1	2	3	4-5	6-10	11-25	26-150	151+		
Businesses with total world-wide sales of										
(1) $0 - $1 million - A	16	0	0	0	0	0	0	0	0	9
- B	223	52	24	24	9	4	1	0	50	88
(2) $1 million-$25million - A	188	24	6	4	1	1	0	0	38	68
- B	9	0	0	0	0	0	0	0	3	4
(3) $25 million + - A	314	92	49	50	23	12	0	0	54	0
- B	3	0	0	0	0	0	0	0	1	0
Individuals - A	126	25	12	19	4	5	0	1	23	45
- B	6	0	0	0	0	0	0	0	3	5
Total number of firms	319	93	49	58	27	16	3	5	55	103

Notes: See Table 4.

were dependent upon small business enterprises for the majority of their fees). In the case of business enterprises with sales of between $1,000,000 and $25,000,000, 188 or about 60% of the respondents for the smallest CA public accounting firm category, 70% of the CGA respondents, and 66% of the other non-CA firms did not have any clients in this category; whereas for the largest business enterprise group of clients, almost all of the respondents in the smallest categories of public accountants had no clients in this category. The same observation seemed to apply for accounting firms ranging in size from 4 to 5 CA's to between 11 and 25 CA's. That is, well over 75% of the firms in these various categories received none of their gross fees from business firms with total world-wide sales of $25,000,000.

The data in Table 9 reinforce the observations in Table 7 - the dependence upon business firms as clients of public accounting firms. Business firms generated 90.5% on a weighted average basis of the total gross fees of all CA firms responding to the survey. Another 4 1/2% of the gross fees were generated by private individuals.

We conducted a similar empirical exercise with the client fee categories as we did with the service fee categories. We estimated a set of equations relating the proportion of fees earned from business enterprises of different size, and from private individuals as well, to the size of the public accounting firm and a number of selected variables. The results are presented in Table 10.

Table 9

Weighted Average Distribution of Gross Fees
For All CA Firms by Selected Client Groups

Businesses with total world-wide sales of		
(1) $0 - $1,000,000	46.4%	
(2) $1,000,001 - $25,000,000	24.4	
(3) $25,000,001 +	19.7	
All Businesses		90.5
Individuals		4.5
Other		5.0
		100.0

Table 10

Multivariate Regression Results Using Percentage of Fees Earned by Client Group as Dependent Variables

Dependent Variable		Independent Variables							Selected Statistics				
	Constant	ACC7	POSTDUM	AFFINT	DMX	PCFEEAUD	PCFEEBU1	PCFEEBU3	$\bar{R}^2$	F	SEE	Mean	NOBS
PCFEEBU1	75.91	-0.149 (-3.90)	2.06 (1.03)	3.13 (1.08)	-0.17 (-0.05)	-0.218 (-4.71)			0.08	11.51	22.75	74.1	578
PCEEBU2	6.07	0.013 (0.47)	0.65 (0.44)	-1.57 (-0.73)	1.90 (0.76)	0.256 (7.42)			0.10	14.25	16.95	13.0	578
PCFEEBU3	0.97	0.148 (14.70)	0.64 (1.21)	-0.41 (-0.53)	-0.27 (-0.30)	-0.014 (-1.16)			0.30	49.35	6.01	1.1	578
PCFEEIND	36.42	-0.007 (-0.31)	0.22 (0.22)	-0.45 (-0.31)	-3.52 (-2.12)	-0.150 (-6.39)	-0.288 (-13.40)	-0.309 (-3.80)	0.25	29.09	11.27	7.6	578

Definitions and Means: See Table 6.

The results appear to be plausible although some statistical problems do arise from the high degree of multi-collinearity between the number of accountants variable and the proportion of fees earned from auditing. The results demonstrate that the larger the public accounting firm, as measured by the number of CA's/ CGA's employed in these firms, the greater the proportion of fees earned from larger business enterprises. For example, for each additional ten CA's in a firm, the proportion of fees earned from the largest business enterprises increases by 1.5 percentage points and the proportion of fees earned from the smallest business enterprises declines by about 1.5 percentage points. For the auditing variable, we find an inverse relationship between the proportion of fees earned from small business firms and the proportion of fees earned from auditing; thus confirming our prior finding. This result suggests, as before, that small business clients are more likely to demand other public accounting services rather than auditing services.

As for the proportion of fees earned from business enterprises with total world-wide sales of between $1,000,000 and $25,000,000, we find a positive relationship between this proportion and the proportion of fees earned from auditing, suggesting that as a firm becomes larger, it is more likely to require auditing from its public accountant either for statutory reasons, or because lending institutions believe that it is now in a better financial position to afford the cost associated with an audit. In the case of the proportion of fees earned from the largest enterprises, the co-efficient on the auditing variable is statistically

insignificant. However we can argue that the insignificant negative co-efficient is simply a statistical artifact of the multi-collinearity between the auditing variable and the number of accountants.

In all cases, the international affiliates and postal code dummy variables had co-efficients that were statistically insignificant. The co-efficients on the CA/CGA firm dummy variable were also insignificant in the business firm equations. These results suggested that the CGA firms are similar to correspondingly small CA firms in terms of the distribution of their gross revenues by business firms of different size.

The data in Table 11 present an alternative dimension to the size of public accounting firms and as well, measure in a rather crude manner the quantitative demand in terms of the number of clients for the services provided by public accounting firms. There were approximately 100,000 small business clients, slightly over 10,500 middle size business clients, and 1,346 large business clients for the public accounting firms that responded with meaningful values to the questionnaire. Over 30% of all the small business clients dealt with sole proprietorship CA accounting firms, or non-CA firms. Another 33% dealt with public accounting firms with either two or three CA's in them. As for the larger business clients, the largest-sized accounting firms dominated this spectrum of the market. In terms of business clients per firm, the values increased uniformly from a total of about 66 per sole proprietorship and 80 per CGA firm (the other non-CA firms are more comparable to two-CA firms in this respect) to just under 3,000 for each of the five largest CA firms in our sample.

Table 11

Total Number and Average Number of Clients of CA Firms of Different Size, and CGA Firms, by Selected Client Groups

	Number of CAs per firm								CGA firms	Other
	1	2	3	4-5	6-10	11-25	26-150	151+		
Total number of clients										
Businesses with total world-wide sales of										
(1) $0 - $1 million	24,198	12,077	11,312	15,128	11,504	10,531	7027	8192	4266	6669
(2) $1 million-$25 million	598	490	431	113	597	618	1293	5410	29	163
(3) $25 Million +	15	2	0	12	6	10	64	1233	4	0
Individuals	19,523	6661	6322	6372	6122	4011	2700	3616	4884	3678
Average number of clients per firm										
Business with total world-wide sales of										
(1) $0-$1 million	64.7	118.4	202.0	256.4	396.7	658.2	1756.7	1638.4	79.0	66.6
(2) $1 million-$25 million	1.6	4.8	7.7	19.2	20.6	38.6	323.3	1082.0	0.5	62.3
(3) $25 Million +	0.0	0.0	0.0	0.2	0.2	0.6	16.0	246.6	0.1	1.5
All Businesses	66.3	123.2	209.7	275.8	417.5	697.4	2096.0	2967.0	79.6	130.4
Individuals	52.2	65.3	112.9	108.0	211.1	250.7	675.0	723.2	90.4	34.4

Table 11 (continued)

Average number of clients per CA or CGA	Number of CAs per firm 1	2	2	4-5	6-10	11-25	26-150	151+	CGA firms	Other
Businesses with total world-wide sales of										
(1) $0 - $1 million	64.7	59.2	67.3	58.3	50.9	44.2	22.5	6.3	66.7	N/A
(2) $1 million-$25 million	1.6	2.4	2.6	4.4	2.6	2.6	4.1	4.2	0.5	N/A
(3) $25 million +	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.9	0.1	N/A
All Businesses	66.3	61.6	69.9	62.7	53.5	46.8	26.8	11.4	67.3	N/A
Individuals	52.2	32.6	37.6	24.5	27.1	16.8	8.6	2.8	76.3	N/A

The big five had approximately 1,683 clients each in the category of business firm with sales of less than $1,000,000; about 1,082 clients in the category with sales of between $1,000,000 and $25,000,000; and about 247 clients each in the category with over $25,000,000 in sales. As for the number of individuals as clients, we find that for the sole proprietorships each firm had approximately 52 private individuals as clients, and for the largest-size group of public accounting firms, each firm had about 723 private individuals.

On a per accountant basis, we observe some rather interesting results. For example, we find that for the four smallest CA firm categories and for CGA firms, the number of small business clients per CA declines rather dramatically from about 51 for public accounting firms with between 6 and 10 CA's to just over 6 small business clients per CA for the largest-sized public accounting firms. As for the middle-size group of business clients, the number of such clients per accountant ranges between 2.4 and 4.4 (with the exception of the sole proprietorships and CGA firms) and does not seem to display any noticeable trend in relation to the size of the public accounting firm. In the largest client category, the number of such clients per accountant was detectably different from zero for only the two largest CA firm size categories. These values imply that in the smaller public accounting firms the CA's or CGA's are dealing with a rather large number of small clients each. On the other hand, in the larger firms, the CA's are likely to be dealing with a smaller number of small clients, and spending a large

proportion of their time with middle to larger size clients.

We estimated another series of equations using the total number of clients in the three business firm-size groupings and the total number of clients that were private individuals as dependent variables. The results for these equations are presented in Table 12. There are two sets of results. In one case, the group of regressors consist of a constant, the number of CA's/CGA's, a postal code dummy variable, an international affiliate dummy variable, and a CA/CGA firm dummy. In the second set, the list of regressors includes the average hourly billing rate for CA's with over ten years of experience and with only a CA designation, and the number of CA's rather than either CA's or CGA's.[13] The average hourly billing rate served the role of a price variable proxy in the regressions. While the inclusion of a "price" variable suggests that we might have estimated a demand equation for the aggregate services provided by public accounting firms, we believe that the resulting equations are not true demand equations. First of all, the average hourly billing rate is not likely to be an adequate proxy for the prices faced by business clients of different size, particularly given the different combinations of services required and the varying amounts of time required to provide a similar service for business clients of different size. In addition, even if it were true that the average hourly billing rate could serve as an adequate proxy for the prices faced by business clients of different size, there is no guarantee that there is adequate information available to the business

Table 12

Multivariate Regression Results Using Number of Clients by Selected Client Groups as Dependent Variables

Dependent Variables	Constant	CA7	ACC7	POSTDUM	AFFINT	DMX	CAIAR	$\bar{R}^2$	F	SEE	Mean	NOBS
NCLTSBU1	195.12		5.89 (15.09)	-41.40 (-2.06)	-102.81 (-3.45)	60.20 (1.78)		0.33	75.13	236.72	150.4	608
	547.41	4.74 (9.04)		-74.11 (-2.45)	-461.49 (-5.76)		3.09 (2.85)	0.42	68.39	268.78	190.2	374
NCLTSBU2	16.17		3.33 (22.97)	5.04 (0.68)	-18.93 (-1.70)	0.56 (0.04)		0.50	152.51	87.95	16.9	608
	81.81	3.09 (14.46)		2.23 (0.18)	-98.13 (-3.00)		0.47 (1.06)	0.51	96.93	109.60	24.0	374
NCLTSBU3	-3.57		0.94 (43.15)	0.02 (0.01)	2.57 (1.55)	-1.22 (-0.65)		0.77	500.51	13.19	2.2	608
	-11.02	0.98 (30.32)		0.99 (0.53)	11.09 (2.23)		-0.09 (-1.39)	0.76	295.76	16.64	3.2	374
NCLTSIND	152.76		2.72 (8.99)	-50.87 (-3.22)	-38.94 (-1.66)	-3.50 (-0.13)		0.15	27.07	186.51	92.3	609
	279.75	2.33 (5.96)		-68.71 (-3.02)	-171.26 (-2.88)		0.69 (0.85)	0.20	24.89	201.85	110.0	375

Definitions:

CA7 - Number of CA's in a CA firm.
NCLTSBU1 - Number of business clients with sales of $0-$1,000,000.
NCLTSBU2 - Number of business clients with sales of $1,000,001-$25,000,000.
NCLTSBU3 - Number of business clients with sales of $25,000,000+.
NCLTSIND - Number of clients who are individuals.
CAIAR - Average hourly billing rate for CA's who have only a CA designation and have had it for more than 10 years.

See Table 6 for other definitions.

Means:	NOBS=608	NOBS=374
ACC7	4.66	-
CA7	-	6.13
POSTDUM	0.64	0.65
AFFINT	0.98	0.95
DMX	0.91	-
CAIAR	-	33.20

clients to be able to determine or compare relative prices across accounting firms. Indeed, as we will point out in Sections II and III, this latter assumption appears to be rather reasonable in describing the behaviour of the demand side of the accounting industry market. Moreover, it is highly unlikely that we have been able to isolate all the demand side effects and exclude entirely supply side impacts from our equations. Nevertheless, the resulting co-efficients in the equations including the average hourly billing rate do provide some interesting insights into the behaviour of the accounting industry.

Focusing first on the regression results derived from the sample sets with the larger number of observations, we find, as expected, that the number of clients increase in line with the number of CA's/CGA's in a firm. In all cases, the co-efficient on the ACC 7 variable is significantly different from zero at the 99% confidence level. As for the implied results, we find that for each additional accountant in a firm, the firm will have approximately 6 more small business clients, 3.3 medium-size business clients and 0.9 large business clients, in addition to another 2.7 private individuals as clients. The results for the postal code dummy variable seem to confirm earlier speculations regarding differences in client mix and market orientation of accounting firms based within the greater Metropolitan Toronto area and those based outside this area. In the only two equations in which the co-efficient on the postal code dummy variable was significantly different from zero, the co-efficient values were negative. In the case

of small business clients, the results suggest that public accounting firms based outside the greater Metropolitan Toronto area have more clients per firm on average than do the firms based within the greater Metropolitan Toronto area. In the case of private individuals, the firms based outside the greater Metropolitan Toronto area have approximately 5 more clients. Similar results were obtained with the international affiliate dummy variable. In only one case in the larger observation set of equations was the co-efficient statistically significant. In the case of small business clients, accounting firms without international affiliates have approximately 103 more such clients than the firms with international affiliates. Moreover, in only one case was the co-efficient on the CA/CGA firm dummy marginally significant; namely, the small business client equation. The result suggests that a CA firm has about 60 more such clients than a CGA firm.

We find, turning our attention to the results based on the smaller set of observations and including the average hourly billing rate among the independent variables, that in the case of the international affiliate dummy variable the co-efficients are dramatically different than in the large sample set of regressions. We believe the co-efficients demonstrate, in light of the fact that the constant term in most cases is dramatically larger than it was in the large sample case, that this variable is serving the role, to a large degree, of a constant in this group of regressions. In only one case was the co-efficient on the average hourly billing rate variable statistically

significant from zero. The co-efficients were positive for small- and medium-size business clients, and negative and marginally significant in the case of the large business client group. Interpreting these results uncritically suggests that the small- and medium-size business firms either associate higher billing rates with greater quality, lack adequate information for making relative price comparisons or are insensitive to price. The large business clients, on the other hand, appear either to be price conscious or to have the best information about relative prices among different accounting firms.

This latter explanation seems most plausible given our earlier comments on the nature of market segmentation in the accounting industry. Considering the small number of large public accounting firms that effectively operate in the large business client-auditing service spectrum of the market and the market power and concomitant bargaining strength of the large clients, it is conceivable that the business clients do obtain a rather high degree of information about the quality, range and prices of services provided by the large public accounting firms. Again, these findings, if accepted uncritically, seem to support to some extent the contention of the Institute of Chartered Accountants of Ontario that regulation is required in order to protect a relatively ignorant public and to guarantee a minimum quality standard for the remainder of the market. However, at the same time, the results suggest that the main reason for ignorance on the part of the consumer of accounting services is not so much their inability to discriminate in terms

of qualify, at least as far as we can tell from the data presented to this point, but more their lack of information about price, quality and services. It is conceivable that with adequate information made available to the public, the degree of ignorance may be less pronounced than it is at present and perhaps may be much less than anticipated by the current members of the accounting profession. Nevertheless, these comments are at this time speculative and not supported by the data that we have presented thus far.

In Table 13, we present the proportion of fees earned by accounting firms in different fee categories. For CA public accounting firms with only one or two CA's, about 60% of all fees are earned from client dealings in which the fees range between $0 and $1,000. For CGA firms the proportion approaches two-thirds, and for other non-CA firms it is even higher. Firms with between 4 and 25 CA's receive about 38% of the fees in this particular fee category, while for the five largest, only 7% of all fees are earned in this lowest fee category. Overall, for CA firms ranging in size from 1 CA through to 25 CA's, over 85% of the fees are earned in fee categories ranging between $0 and $10,000. For the five largest firms, only 32% of the fees are earned in these categories. As expected, the proportion of fees earned in the larger fee categories increases with the size of the accounting firm. In the five largest firms, 40% are earned in fee categories of between $10,000 and $50,000, and 27.6% of the fees are earned in engagements with fees in excess of $50,000. It appears, putting these results together with previous ones, that the smaller

Table 13

Percentage of Gross Fees Earned by CA Firms of Different Size and CGA Firms by Fee Categories

	Number of CAs per firm								CGA Firms	Other
Fee category	1	2	4	4-5	6-10	11-25	26-150	151+		
$0 - $1,000	60.5%	60.2	46.4	37.7	38.5	38.0	27.2	7.0	66.7	71.7
$1,001-$10,000	31.6	34.8	43.8	50.1	47.8	47.2	39.8	25.0	31.4	27.2
Total $10,000 or less	92.1	95.0	90.2	87.8	86.3	85.2	67.0	32.0	98.1	98.9
$10,001 - 50,000	7.0	5.0	9.8	12.2	13.7	13.2	26.0	40.4	1.0	1.1
50,001 +	0.6	0.0	0.0	0.0	0.0	1.6	7.0	27.6	0.9	0.0

public accounting firms deal with small business clients, are more likely to provide them with non-audit reviews than with audits, and at the same time are more likely to spend less time in providing these other public accounting services to their clients. Once more, the high proportion of fees earned by small accounting firms in the $0 to $1,000 fee category places into serious question the contention of public accountants that they view their role as financial advisors rather than number grinders. As for the larger public accounting firms, they concentrate more on providing auditing services to larger business clients.

It appears that we can characterize the public accounting industry by a 2 x 2 matrix, with size of business firm along one dimension and auditing and other public accounting along the other dimension. We can also overlay these four segments with time devoted to providing these services or fee categories. However, complicating the matrix and making it three-dimensional will not dramatically change the market structure; namely, that in the segments in which the largest business clients operate, whether they demand auditing or other public accounting services, the largest public accounting firms dominate and in the segments in which small business clients are demanding only other public accounting services, the smallest public accounting firms dominate. Thus, market segmentation (see Figure 1) appears to be a reality of the accounting industry and any discussion related to regulatory regimes, quality standards, training etc. must be presented within the context of such segmentation.

Table 14

Weighted Average Distribution of Gross Fees
For all CA Firms, by Fee Categories

0 - $1,000	28.5%
$1,001 - $10,000	34.5
$10,001 - $50,000	24.5
$50,000 +	12.6

Figure 1

Dominant Public Accounting Firms in Four Market Segments

Business Clients	Public Accounting Service: Audits	Public Accounting Service: Other
Large	Large P.A. Firms	Large P.A. Firms
Small	Large & Small P.A. Firms	Small P.A. Firms

The regression results, using the proportion of fees earned in the different fee categories as dependent variables, are presented in Table 15. In this set of results, the generally low t scores for the co-efficient estimates for the accountants variable and proportion of fees earned from large business client variables were the result of the high degree of multi-collinearity between these variables. In addition, the proportion of fees earned from auditing was also highly correlated with these two variables, and in some cases, the co-efficient estimates and the t scores were unreliable because of multi-collinearity. Nevertheless, we find that the larger the firm, as measured in terms of number of CA's or CGA's, the higher the proportion of fees earned in the larger fee categories. As for the relationship between proportion of fees earned in the various fee categories and the proportion of fees earned from different size business clients, we observe the expected positive co-efficients in the case of the lowest fee category ($0 to $1,000) and the proportion of fees earned from small business firms. The higher the proportion of fees earned from the small business client, the larger the proportion of fees

Table 15

Multivariate Regression Results Using Percentage of Fees Earned by Fee Category as Dependent Variables

Dependent Variables	Independent Variables								Selected Statistics				
	Constant	ACC7	POSTDUM	AFFINT	DMX	PCFEEAUD	PCFEEBU1	PCFEEBU3	$\bar{R}^2$	F	SEE	Mean	NOBS
PTOTFEE1	55.03	-0.039	-9.66	0.08	-6.55	-0.295	0.269	-0.183	0.17	17.71	26.94	55.2	559
		(-0.72)	(-4.01)	(0.03)	(-1.61)	(-5.22)	(5.17)	(-0.88)					
PTOTFEE2	27.14	-0.064	6.13	1.97	0.75	0.343	-0.074	-0.206	0.11	10.87	23.27	36.1	559
		(-1.38)	(2.94)	(0.66)	(0.21)	(7.01)	(-1.64)	(-1.15)					
PTOTFEE3	16.93	0.090	3.77	-1.78	6.60	-0.047	-0.202	-0.107	0.11	10.73	16.71	7.9	559
		(2.69)	(2.52)	(-0.83)	(2.61)	(-1.33)	(-6.25)	(-0.83)					

Definitions:

PTOTFEE1 - Percentage of fees earned in \$0-\$1,000 fee category.
PTOTFEE2 - Percentage of fees earned in \$1,001-\$10,000 fee category.
PTOTFEE3 - Percentage of fees earned in \$10,001-\$50,000 fee category.

See Table 6 for other definitions.

Means:

ACC7	- 4.91	PCFEEAUD	- 24.45
POSTDUM	- 0.65	PCFEEBU1	- 74.07
AFFINT	- 0.98	PCFEEBU3	- 1.06
DMX	- 0.91		

earned in the lowest fee category. This supports our earlier supposition that non-audit reviews or non-reviews are the primary public accounting service provided to these firms and the time required by public accounting firms to provide these services is rather limited.

With the exception of the largest fee category, we find that for the fee categories $1,000 to $10,000 and $10,000 to $50,000, the proportion of the gross fees earned in these categories declines with an increase in the proportion of fees earned from small business firms. There is a strong positive interrelationship between the proportion of fees earned from large business enterprises and the proportion of fees earned in the largest fee categories, once more lending further credence to our market segmentation model.

The postal code dummy co-efficients suggest that the public accounting firms with head offices in the greater Toronto area tend to receive approximately 9.7 percentage points less of their fees in the smallest fee categories than do firms based outside the greater Metropolitan Toronto area. The public accounting firms based in the greater Metropolitan Toronto area earn about 6 and 4 percentage points more of their fees in the $1,000 to $10,000 fee category and $10,000 to $50,000 fee category respectively than do the other firms. In the largest fee category, the co-efficient on the postal code dummy variable was statistically insignificant. The problems stemming from multi-collinearity

seem to cast into doubt the values and signs of the co-efficient estimates for the proportion of fees earned in the provision of auditing services. But in the only two cases in which the co-efficients were statistically significant at the 99% confidence level we find that the proportion of fees earned in the lowest fee category declines if the proportion of fees earned in the provision of auditing services increases, and conversely, the proportion of fees earned in the $1,000 to $10,000 category are positively related to the proportion of fees earned in the provision of auditing services. These results are consistent with the expectations that auditing is a more time consuming and hence more costly service than non-audit reviews.

In Table 16, we present data on the total number of clients in the various fee categories for public accounting firms of different size, as well as the average number of clients per firm and the average number of clients per CA. We were able to calculate that there were a total of 184,101 clients for all the respondents. Of this number, public accounting firms with only 1 CA had 40,509 clients or 22 per cent of all clients of all the public accounting firms in Ontario. The CA firms in the next two smallest size categories (2 and 3 CA's) had an additional 38,377 clients, while the CGA firms had 9,874 clients, and other non-CA firms had 9,956 clients. Thus, public accounting firms in these small-size categories accounted for almost 54% of all clients. These groups of public accounting firms represented over 60% of the clients in the lowest fee category, just under 30% of the clients in the $1,000 to $10,000

Table 16

Total Number and Average Number of Clients of CA Firms of Different Size, and CGA Firms, by Fee Categories

	Number of CAs in firm								CGA firms	Other
Total number of clients in following fee categories	1	2	3	4-5	6-10	11-25	26-150	151+		
$0 - 1,000	36,428	17,075	14,924	15,653	12,676	11,170	6757	9478	9211	9251
$1,001 - $10,000	3740	2744	3478	6466	4631	4712	3797	7064	658	693
$10,001 - 50,000	337	61	95	171	148	238	319	1799	4	12
$50,001 +	4	0	0	0	0	6	22	278	1	0
Total	40,509	19,880	18,497	22,290	17,455	16,126	10,895	18,619	9874	9956
Average Number of clients per firm in following fee categories										
$0 - 1,000	97.4	167.4	266.5	265.3	437.1	698.1	1689.3	1895.6	180.6	79.8
$1,001 - $10,000	10.0	26.9	62.1	109.6	159.7	294.5	949.3	1412.8	12.9	6.0
$10,001 - 50,000	0.9	0.6	1.7	2.9	5.1	14.9	79.7	359.8	0.1	0.1
$50,001 +	0.0	0.0	0.0	0.0	0.0	0.4	5.5	55.6	0.0	0.0
Total	108.3	194.9	330.3	377.8	621.9	1007.9	2723.8	3723.8	193.6	85.9

Table 16 (continued)

Average number of clients per CA or CGA in following fee categories										
$0 -$1,000	97.4	83.7	88.8	60.3	56.0	46.9	21.6	7.3	153.5	N/A
$1,001 - $10,000	10.0	13.4	20.7	24.9	20.5	19.8	12.1	5.4	10.9	N/A
$10,001 - $50,000	0.9	0.3	0.6	0.7	0.7	1.0	1.0	1.4	0.1	N/A
$50,001 +	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.0	N/A
Total	108.3	97.4	110.1	85.9	78.2	67.7	34.8	14.3	164.5	N/A

fee category and about 15% of the clients in the second largest fee category. The five largest public accounting firms dominated in terms of the numbers of clients in the largest two fee categories.

We observe in Table 16 that the total number of clients per firm increases uniformly from 86 clients per firm for the non-CA, non-CGA firms to an average of 3,724 clients per firm for the big five CA firms. For the big five, there are about 56 clients per firm in the $50,000 and over fee category. Comparing this figure with the corresponding average number of business clients with total worldwide sales of $25,000,000 or more for each of the big five (Table 11), we find that a very high proportion of the large business clients must be in the $50,000 and over fee category. At the same time, a comparison of the number of clients in the lowest fee categories for each of the public accounting firm-size categories (Table 16) with the number of small business clients and the number of private individuals per firm (as presented in Table 11) suggests that a large fraction of these business clients, as well as of private individuals, pay fees for various kinds of public accounting services, totalling no more than $1,000. Hence, the range of services provided to these client groups and the time input of CA's/CGA's is rather limited in most cases, averaging likely less than three or four man-days per client.

With respect to the number of clients per CA, we see that there are between 97 and 110 clients per CA for the three smallest

public accounting firm-size categories. As a rough approximation, these figures suggest that each CA spends about two to two and one-half days with each client on average. In the CGA firms, there are an average of 164 clients per CGA. For public accounting firms with more than three CA's, the number of clients per CA drops sharply from just under 86 clients per CA in accounting firms with four to five CA's to just over 14 clients per CA for the five largest firms. These figures translate into more CA days per client in the larger firms. But obviously, in order to service larger business clients and generate larger engagement fees, more days must be devoted to each client.

A question arises, in light of these figures: do the clients of small public accounting firms receive adequate service from their public accounting firms given the small number of days that each CA and especially CGA spends in dealing with the affairs of the client? At the same time, do the clients of the larger public accounting firms receive too much attention in light of the much greater number of days devoted by each CA to each client? It is possible that the accounting problems or the services required by smaller clients are less time consuming and more simple and routine than are the problems encountered in servicing the larger business clients, and thus all clients of all public accounting firms may be receiving an adequate level of attention. However, this is speculative and as with other questions posed earlier, cannot be adequately answered with the data that we have available.

In order to further examine some of the relationships that we have speculated upon, we estimated a series of regressions using the number of clients in the various fee categories as dependent variables. The regression results are presented in Table 17. There are two sets of variables for which we have results. Focusing on the results for the larger sample set (the set of equations that include only the constant, the number of accountants, the postal code dummy, international affiliate dummy, and CA-CGA firm dummy among the regressors), we find once more that the number of clients in all the fee categories increases with the number of CA's or CGA's in the firm. For example, for each additional accountant in a firm, the total number of clients increases by about 15.8, with the breakdown being as follows: 8.6 additional clients in the lowest fee category, 5.7 in the $1,000 to $10,000 fee category, 1.2 in the $10,000 to $50,000 fee category and 0.2 in the largest fee category.

The postal code dummy co-efficients imply that firms based outside the greater Metropolitan Toronto area have a much larger number of clients vis-à-vis those based within that area in the lowest fee categories; while the public accounting firms based within the greater Metropolitan Toronto area have a marginally larger number of clients in the larger fee categories.

We find in the equations that include the average hourly billing rate among the regressors that the clients in the fee category

Table 17

Multivariate Regression Results Using Number of Clients by Fee Category as Dependent Variables

Dependent Variables	Independent Variables							Selected Statistics				
	Constant	ACC7	CA7	POSTDUM	AFFINT	DMX	CAIAR	$\bar{R}^2$	F	SEE	Mean	NOBS
NTOTCLT1	357.06	8.63 (12.74)		-85.77 (-2.41)	-140.45 (-2.66)	3.93 (0.06)		0.26	53.00	416.24	211.3	594
	1003.76		6.98 (7.30)	-101.21 (-1.83)	-741.84 (4.96)		-0.46 (-0.23)	0.32	44.14	486.21	261.6	366
NTOTCLT2	78.85	5.68 (27.87)		0.95 (0.09)	-74.55 (-4.69)	28.61 (1.56)		0.62	246.12	125.25	60.8	594
	417.83		4.70 (17.98)	-2.44 (-0.16)	-404.95 (-9.90)		0.68 (1.22)	0.73	241.59	132.90	83.6	366
NTOTCLT3	12.66	1.25 (17.46)		3.78 (1.00)	-14.90 (-2.68)	0.77 (0.12)		0.39	95.76	43.90	7.4	593
	85.54		1.02 (9.61)	4.23 (0.69)	-85.22 (-5.12)		-0.09 (-0.39)	0.41	65.65	54.05	10.8	366
NTOTCLT4	-1.20	0.19 (8.66)		0.82 (0.69)	0.54 (0.31)	0.30 (0.15)		0.12	20.80	13.80	1.1	592
	-1.19		0.20 (5.72)	2.04 (1.03)	3.51 (0.65)		-0.10 (-1.32)	0.10	10.60	17.43	1.6	365

Definitions:

NTOTCLT1 - Number of clients in $0-$1,000 fee category.
NTOTCLT2 - Number of clients in $1,001-$10,000 fee category.
NTOTCLT3 - Number of clients in $10,001-$50,000 fee category.
NTOTCLT4 - Number of clients in $50,001+ fee category.

Means:	NOBS=593	NOBS=366
ACC7	4.95	-
CA7	-	6.56
POSTDUM	0.64	0.64
AFFINT	0.98	0.95
DMX	0.91	-
CAIAR	-	33.04

$1,000 to $10,000 are not price sensitive in the traditional demand sense. That is, the number of clients in this fee category does not decline if the average hourly billing rate of a public accounting firm increases. On the other hand, the clients in the other three fee categories do seem to display the traditional response to higher average billing rates and hence perhaps higher average prices. These results seem partially to confirm earlier ones suggesting that larger clients and/or those facing large fees, however, appear to be sensitive to price, and perhaps do devote time to obtaining price and quality information about the various public accounting firms. But as noted in several places above, the nature of the segment in which these clients operate makes it easier for them to obtain information.

In Tables 18 and 19, we present data for the proportion of auditing fees earned in the various fee categories and the proportion of other public accounting fees earned in the various fee categories by accounting firms of different size. In the case of auditing fees, there is a noticeable inverse correlation between the proportion of auditing fees earned in the $0 to $10,000 fee categories and the size of the accounting firms. For the sole proprietorships, and non-CA firms, at least 95% of auditing fees are earned in the lowest two fee categories, while just under 30% of the auditing fees are earned in these categories by the big five. Moreover, the larger the public accounting firm, the more likely that the auditing fees are earned in the $1,000 to $10,000 fee category rather than the $0 to $1,000 fee category. For the two largest

Table 18

Percentage of Gross Auditing Fees Earned by
CA Firms of Different Size, and CGA Firms, by Fee Categories

	Number of CAs per firm								CGA firms	Other
Fee category	1	2	3	4-5	6-10	11-25	26-150	151+		
$0 - $1000	41.2%	29.4	18.1	14.4	13.1	18.8	13.2	4.2	46.9	59.9
$1001 - $10,000	56.4	62.6	68.3	69.1	60.0	63.0	49.0	25.4	48.3	35.1
Total $10,000 or less	97.6	92.0	86.3	83.5	73.1	81.8	62.2	29.6	95.2	95.0
$10,001 - $50,000	1.8	7.9	13.6	16.6	26.9	16.6	29.5	42.2	4.8	3.8
$50,001 +	0.5	0.0	0.0	0.0	0.0	1.6	8.2	28.2	0.0	0.0

Table 19

Percentage of Gross Other Public Accounting Fees Earned
by CA Firms of Different Size, and CGA Firms, by Fee Categories

	Number of CAs per firm								CGA firms	Other
Fee category	1	2	3	4-5	6-10	11-25	26-150	151+		
$0 - $1000	75.7%	72.9	63.7	56.5	50.5	60.4	70.8	52.4	78.7	71.7
$1001 - $10,000	20.1	26.0	34.5	39.5	48.8	33.9	27.8	44.2	20.8	27.2
Total $10,000 or less	95.8	98.9	98.2	96.0	99.3	94.3	98.6	96.6	99.5	98.9
$10,001 - $50,000	3.9	1.1	2.6	3.9	0.8	1.0	1.5	3.2	0.6	1.1
$50,001 +	0.5	0.0	0.0	0.0	0.0	4.7	0.0	0.2	0.0	0.0

groups of public accounting firms, the proportion of auditing fees earned in the largest fee category does represent a significant proportion of the total auditing fees earned. For the big five, 28.2% of all auditing fees are earned in engagements where the client pays a fee in excess of $50,000.

For public accounting fees we find that there is no inverse or direct positive correlation between the proportion of fees earned in the lowest fee categories and the size of public accounting firm. Between 94% and 99% of all public accounting fees are earned from engagements in which the fees range between $0 and $10,000. However, for the smaller public accounting firms, a much larger proportion of their public accounting fees are earned in the $0 to $1,000 engagements (for sole proprietorships, 76% of the other public accounting fees are in this category, whereas only 52.4% of the total other public accounting fees are earned in this category by the big five), while a larger proportion of the fees are earned in the $1,000 to $10,000 category by the larger firms.

A comparison of the proportion of fees earned in the lowest fee categories for auditing and other public accounting demonstrates that less time goes into a non-audit review engagement than into audit engagements. As for public accounting firm comparisons, the results suggest, at least for other public accounting services, that either the larger firms are dealing with larger clients and therefore must devote more time in preparing non-audit reviews

or they undertake more extensive non-audit reviews than is the case for the smaller public accounting firms. Whatever the actual case may be, there does arise a question as to whether there is a uniformity in the standards of non-audit reviews as undertaken by public accounting firms of different size. However, as we will discuss below in Chapter 4, there seems to be evidence suggesting that there definitely is not a uniform standard across firms in the provision of non-audit reviews. Indeed, this particular "output" is heterogeneous.

In Table 20, we report that there were 42,129 auditing clients among the public accounting firms that returned meaningful responses, and 81,859 other public accounting clients. In the four smallest CA public accounting firm size categories, and in the non-CA, non-CGA firm category, the number of public accounting clients is generally between three and five times the number of auditing clients (CGA firms have almost nine times as many other public accounting clients as audit clients); whereas in the two largest public accounting firm size categories, the number of auditing clients was generally between two and three times the number of other public accounting clients. This same information can be observed in comparing the number of auditing clients per firm, and the number of other public accounting clients per firm. For example, for sole proprietorships each firm had about 55 other public accounting clients and only 15 auditing clients. For public accounting firms with four or five CA's, the values were about 198 other public accounting clients per firm and 72 auditing clients per firm. For public accounting firms in the 26 to 150 CA category, there were 1,454 auditing clients per firm and only 516 other public accounting clients, and for the big five, 2,214 auditing

Table 20

Number and Average Number of Auditing and Other Public Accounting Clients of CA Firms of Different Size and CGA Firms

CAs per firm	Total Number	Average per firm	Average per CA or CGA
		Auditing Clients	
1	5647	15.1	15.1
2	2825	27.7	13.8
3	2593	46.3	15.4
4-5	4218	71.5	16.2
6-10	3619	124.8	16.0
11-25	4869	304.3	20.4
26-150	5816	1454.0	18.6
151+	11072	2214.4	8.5
CGA firms	254	8.2	7.1
Other	1216	15.4	N/A
		Other Public Accounting Clients	
1	20,458	54.7	54.7
2	12,658	124.1	32.6
3	8512	152.0	37.6
4-5	11,676	197.9	24.5
6-10	8799	303.4	27.1
11-25	6331	395.7	16.8
26-150	2064	516.1	8.6
151+	4602	920.4	2.8
CGA firms	2225	57.1	61.8
Other	4534	54.6	N/A

clients per firm and 920 other public accounting clients per firm. We also find that the number of audit clients per CA appears to rise marginally from the smallest public accounting firm size category to the second largest size category. This seems to be in contrast with the earlier observation where the total number of clients per CA tended to decline with increasing size of firm, (once past the firm category of three CA's). However, with other public accounting, we find that the average number of clients per CA does tend to decline (once we go beyond the size category of 2 CA's) as the size of the firm increases. These various ratios support our contention that there is distinct segmentation in the markets in terms of provision of auditing and other public accounting services.

The final set of regression results for this section are presented in Table 21. We estimated relationships between the number of auditing clients or the number of other public accounting clients and the number of accountants, location of public accounting firms and average hourly billing rates. In examining the results for the larger sample set (the equations excluding average hourly billing rate), we observe that for each additional CA or CGA, the number of auditing clients increases by about 8 and the number of other public accounting clients increases by only about 2.7. These different co-efficient estimates, which were significantly different from one another, point to the importance of public accounting firm size in performing audits vis-à-vis other public accounting services.

Table 21

Multivariate Regression Results Using Number of Auditing Clients and Other Public Accounting Clients and Dependent Variables

Dependent Variables	Independent Variables							Selected Statistics				
	Constant	ACC7	CA7	POSTDUM	AFFINT	DMX	CAIAR	$\bar{R}^2$	F	SEE	Mean	NOBS
CLTAUD	108.53	8.28 (30.15)		2.57 (0.16)	-86.00 (-4.00)	2.66 (0.08)		0.68	278.32	168.34	74.3	514
	532.95		7.02 (20.31)	5.22 (0.26)	-521.19 (-9.36)		0.26 (0.33)	0.77	281.78	173.11	96.7	341
CLTACC	133.71	2.70 (9.56)		-42.37 (-2.66)	-63.04 (-2.85)	68.18 (2.33)		0.21	34.62	173.35	123.5	508
	369.83		1.84 (4.86)	-60.33 (-2.58)	-289.72 (-4.72)		2.47 (2.68)	0.30	34.56	189.78	153.1	310

Definitions:

CLTAUD - Number of auditing clients.
CLTACC - Number of other public accounting clients.

Means:	NOBS=508	NOBS=310
ACC7	5.45	-
CA7	-	7.34
POSTDUM	0.62	0.63
AFFINT	0.98	0.95
DMX	0.93	-
CAIAR	-	33.35

There did not appear to be any statistically significant difference in the number of auditing clients per firm among the firms based in various regions of Ontario. However, the firms based outside the greater Metropolitan Toronto area did appear to have approximately 42 more other public accounting clients than those in the greater Metropolitan Toronto area. Firms with international affiliates appeared to have approximately 86 more auditing clients and 63 more other public accounting clients than firms that do not have such international affiliates.

The co-efficient estimates for the international affiliates dummy in the expanded set of regressions were implausibly large, but this could simply be the result of this variable once more playing the role of a constant when a price variable is added to the regressors. Turning our attention to the average hourly billing rate variable, we find that neither group of clients displays the standard demand response to higher average hourly billing rates although the co-efficient was statistically insignificant for the number of audit clients.

Thus far, we have given a statistical overview of the accounting market focusing on the different demand characteristics for public accounting firms of various size, and providing data that tended to display a high degree of segmentation of the accounting industry. In traditional industrial organization studies however, the key statistics that are of concern in describing industry structure are measures of the degree of market concentration (market imperfection on the supply side of the industry). The most

common measures of industry structure are concentration ratios; that is, the proportion of industry demand, production, sales provided by the largest X number of firms. The larger the concentration ratio, the more imperfectly competitive (the more oligopolistic or monopolistic) is the market on the supply side. The lower the value of the concentration ratio the more competitive is the market and hence the more efficient should be the functioning of the market.[14]

As we pointed out in the overview to this chapter, market efficiency is not an important concept, at least in our opinion, in discussing the accounting "industry". The effects of the behaviour of the participants in this market on the efficient functioning of the economy as well as the achievement of certain so-called macro goals is much more relevant. Nevertheless, in Table 22, we set out a whole series of concentration ratios, providing estimates of the degree of market imperfection on the supply side of various service categories. This is in line with our contention that there is market segmentation, and so we have broken up the market into several layers, in terms of services and in terms of client characteristics, and have provided concentration ratios for each of these layers.

The concentration ratios presented are for the largest five firms and the largest nine firms since the data were most easily obtained for these public accounting firms. There are several limitations to the resulting concentration ratios. First of all,

the non-CA firms were excluded from the data base.[15] Secondly, and more important, three of the largest public accounting firms in the province did not respond to the survey. However, since we did not get a 100 per cent response from public accounting firms in all size categories, it is difficult, indeed impossible, to estimate the extent and direction of the bias in the reported concentration ratios. All we can suggest is that the reported values are not exact but they do appear to be reasonable and in a highly plausible range. In the case of the number of CA's, the total number of employees and the number of students, the concentration ratios were based directly on counts of actual numbers. Thus, while the nine largest firms accounted for only 1.4% of all the CA public accounting firms in our sample, they employed 52.4% of all CA's, 66.4% of all students, and just under 53% of all employees in such firms. The values for the five firm concentration ratios for the corresponding variables suggest the existence of an oligopolistic market structure, at the aggregate level, for the accounting profession in Ontario. The public accounting industry is far from a monopolistic structure but it is equally far from a perfectly competitive structure.

The next series of concentration ratios to look at are those for the numbers of clients in various categories. Here again, the concentration ratios were calculated by counting the actual number of clients. As expected, the concentration ratios are extremely low for the small business client category, and increase for the medium and large business client categories.

Indeed, on the basis of the values,we can conclude that a highly competitive structure exists in the small business client segment of the industry and that a quasi-monopolistic structure exists in the large business client segment. The same relationships appear when we examine the concentration ratios for the number of clients in the various fee categories. Once more, the degree of market imperfection increases as we move towards the higher fee categories. Oligopolistic and quasi-monopolistic structures tend to prevail in the fee categories of $10,000 or more.

In Table 22, we have also presented five-firm and nine-firm concentration ratios for different categories of fees. Since data were not available from the surveys on the aggregate gross fees of each CA public accounting firm, we were forced to estimate a proxy for gross fees. As a proxy for the gross fees of each firm in the various fees groupings, we took the product of the proportion of fees earned by a firm in a particular category and the number of CA's in the firm. Performing this calculation for all the firm size categories listed in the previous tables, we were then able to estimate a total gross fee figure for all public accounting firms and calculate the corresponding concentration ratio.[16] The concentration ratios thus constructed are not likely to be precise measures, although we believe they are, if anything, underestimates of the true values. The reason for this is that it is not likely that gross fees will be directly related to the number of CA's in a firm. That is, one CA will not be worth X thousands of dollars in gross fees in each firm size category.

Table 22

5-Firm and 9-Firm Concentration Ratios for Selected Variables

	5-firms	9-firms
Number of Firms	0.8%	1.4
Number of CAs	42.3	52.4
Number of students	49.8	66.4
Number of individuals in firm	39.7	52.9
Number of clients		
BU1[A]	8.2	15.2
BU2[B]	51.2	63.4
BU3[C]	91.9	96.6
CLT1[D]	7.6	13.1
CLT2[E]	19.3	29.6
CLT3[F]	56.8	66.9
CLT4[G]	89.7	96.8
CLTAUD[H]	27.2	41.5
CLTACC[I]	6.1	8.9
CLTIND[J]	6.5	11.4

Table 22 (continued)

Fees		
Auditing	59.0	69.4
Other Public Accounting	14.1	22.1
Corporate Taxation	44.6	56.2
Book-Keeping	6.7	16.8
BU1[A]	17.9	26.9
BU2[B]	53.3	67.4
BU3[C]	90.8	97.5
$0 - $1,000	10.4	20.1
$1,001 - $10,000	30.7	42.4
$10,001 - $50,000	69.8	80.6
$50,001 +	92.8	98.4

Notes:

A - Businesses with total sales of $0 - $1,000,000
B - Businesses with total sales of $1,000,001 - $25,000,000
C - Businesses with total sales of $25,000,001 +
D - Clients that paid gross fees of $0 - $1000
E - Clients that paid gross fees of $1001 - $10,000
F - Clients that paid gross fees of $10,001 - $50,000
G - Clients that paid gross fees of $50,001 +
H - Auditing clients
I - Other public accounting clients
J - Individuals

Larger firms are likely to have a higher overhead and are more likely to have a larger number of high-priced specialists. Nevertheless, despite the obvious shortcomings, the concentration ratios derived from the fee data exceed corresponding concentration ratios based on the number of clients.

As expected, the concentration ratio for auditing fees are extremely high, 59% for the five-firm ratio, 69.4% for the nine-firm ratio. The latter nine-firm ratio compares to a 41.5% concentration ratio based on the number of auditing clients. This comparison, together with the data presented earlier, suggest that not only do the larger firms specialize in the provision of auditing services; but also they tend to concentrate in providing these services to larger clients and/or for larger fees per engagement. With regards to other public accounting services, the concentration ratios suggest that there is a much higher degree of competition than there is in the auditing field. The concentration ratios for other public accounting are well within the realm of what has been labelled a competitive market range.

Data were also available to calculate concentration ratios for corporate taxation services and bookkeeping services. However, we should point out that these concentration ratios were calculated by excluding other suppliers of these type of services and as a result underestimate the degree of competition in these areas. Despite this problem, the concentration ratios imply a relatively high degree of competition in the provision of bookkeeping services,

but a much smaller degree of competition in the provision of corporate taxation services.

Among the business clients categories we find, as before, that the degree of competition tends to decline as we move from the smaller business clients, those with sales of less than $1 million to the largest business clients, those with sales of more than $25 million. Indeed for the largest client group, 97.5% of total fees earned by accounting firms appear to be accounted for by the largest nine firms. Finally, the same relation as we observed before, between concentration ratios and fee categories, is apparent when we examine the concentration ratios based on fees. The degree of competition declines as we move into the higher fee categories. For example, in the fee ranges $0 - $1,000, the five-firm and nine-firm concentration ratios are 10.4% and 20.1% respectively; while in the $50,000 and over fee category, the corresponding ratios are 92.8% and 98.4% respectively. The various data on concentration ratios support our earlier contention that there is a distinct segmentation of the accounting market. On the demand side, there is two-way segmentation on the basis of services demanded and on the basis of client size. On the supply side, there is a one way segmentation based on the size of the public accounting firm.

One final set of data that we present in this section, related to the CA public accounting firms, are revised estimates of the number of client-days per CA in a firm and per employee in

a firm. In effect, the ratios calculated and reported in Table 23, present a rough estimate of the relative degrees of excess demand or supply in the public accounting market. We can hypothesize that the greater the number of client-days per CA or per employee, the more likely the market is characterized by excess demand for services and conversely, the smaller the number of client-days per CA or employee, the more likely the market is characterized by excess supply conditions. In order to calculate the number of client-days per firm and then in turn per CA and employee, it was necessary to make certain assumptions relating to the average fee in the four fee categories, the average fee per client-day and inter-firm differences in average fees in the various categories.[17]

The figures in Table 23 are somewhat surprising. Contrary to the expectation that the CA's in sole proprietorships would be overworked relative to the CA's in the largest firms, we tend to find that the adjusted number of client-days per CA's increases with firm size for firms with one CA to those with four to five CA's, and then declines thereafter as the firm size increases. However, the number of client-days per CA in the largest firm size categories exceeds the number of client-days per CA in the two smallest firm size categories. Furthermore, the figures are rather dramatically in excess of 425 client-days per CA. When the total number of client-days is spread out over the total number of employees in a firm, we no longer observe any type of

Table 23

Adjusted Number of Client-Days Per CA and Per All Individuals in the Firm, by CA Firms of Different Size

CAs per firm	Clients per CA					Clients per all individuals
	CLT1[A]	CLT2[B]	CLT3[C]	CLT4[D]	Total	Total
1	171.2	218.0	35.2	1.5	426.0	255.1
2	170.2	240.0	25.1	-	435.3	212.3
3	131.3	302.3	49.3	-	482.9	240.2
4-5	106.7	345.7	61.5	-	513.9	227.4
6-10	109.0	329.7	69.1	-	507.8	233.0
11-25	107.5	325.7	66.6	4.1	503.8	230.1
26-150	77.0	274.6	131.1	17.9	500.6	185.4
151 +	19.8	172.5	203.6	70.7	466.6	243.0

Notes: A - D: See Table 22

relationship occurring between the number of client-days per employee and firm size.

If we use a criteria such as 50 weeks and 5 days per week as indicating the full capacity of a firm, we find that only in the sole proprietorships does the number of client-days per employee exceed the full capacity level; that is, 255.1 client-days per employee versus the 250 days capacity figure. For two other categories (three CA firms and the big five), the adjusted client-days per employee are only marginally below the full capacity figures. As we pointed out before however, it is conceivable that for the larger firms an estimate of $250 per day as representing one client-day may be an underestimate and, therefore, the client-days per employee and per CA figures may be overestimates as a result. Only in the two CA firm category and the 26 to 150 CA's firm category does there appear to be a high degree of excess capacity. In all other cases, the firms appear to be operating either at or quite close to capacity. What these figures tend to suggest is that if there is any excess supply of services in the accounting profession in Ontario, it is rather minimal and not significant enough according to the data in Table 23 to generate any dramatic downward pressures on prices or quality of services. In addition, given the estimate of workloads per CA, not only in terms of doing their work, but also in terms of supervising non-CA employees, a question arises as to whether the time input in providing the various services, particularly the public accounting services, are appropriate for

guaranteeing high quality standards. It is not necessary in all cases to provide the optimal quality standard. In fact, it is conceivable that most clients would not want that standard given the commensurately higher fees. However, this issue is still important in light of the claims made in support of regulating the industry. We will return to this issue in Chapter 4.

Section II: Client/Firm Matching Process

The traditional economic model hypothesizes that a firm attempts to combine a group of inputs in order to produce a range of products in order to maximize profits or the present value of the firm (the present value of future expected profits). The inputs generally considered in such a model are the basic factors of production, such as labour, capital and land. The model has been extended to include energy and intermediate goods as inputs. The model can also be extended to include inputs of services other than direct labour and capital services which are used in the production of a specific good. For example, the model can be modified to include the use of financial services, legal services, accounting services, etc.; services which are not generally considered in the standard model as necessary for producing an output and maximizing profits. However, the use of financial services, legal services, management advisory services, etc. can improve the efficiency of the administrative and coordination functions of management and hence, reduce costs

and/or increase sales or, in turn, reduce the risks associated with production (as in the case of obtaining legal services in order to set up contracts, minimizing hazards and risks to the firm). In addition, services such as taxation advisory services can reduce the tax burden and thus increase the after-tax profits of a firm. Thus, it is obvious that these non-traditional types of services can be and should be incorporated into an expanded version of the theory of the firm.

Once we allow for these services as inputs into the production, administrative, coordinating, and marketing functions of a firm, we also must make allowances in the development of our theory for differences in the qualities of these services. Quality differences exist as well for the primary inputs. What we can conclude though, at this point, is that, if a complete model along the lines outlined above is developed, the profit maximizing conditions and hence, the demand functions for these services will be determined by the usual marginal cost - marginal revenue, maximization conditions. That is, a particular service, both in terms of quantity and quality, will be demanded up to the point at which the additional cost per quality unit will be equal to the additional revenues generated by that quality unit. Theoretically, it is a straightforward matter, to derive demand functions.

In the real world, however, information is not perfect and markets do not exist in which all the principal actors can easily

come together. Search is necessary in order to obtain information as well as to track down the various participants on the supply side of the market. (Search is also required by suppliers in order to track down customers on the demand side - this is prevalent in producer goods areas.)

Therefore, when a firm has determined, in light of its expectations of price and quality, the optimal level of a particular input or service that it requires, it does not simply go to a central marketplace and purchase the desired quantity and quality of a service or other input from the suppliers in the particular market. Instead, the firm is required to search out the suppliers and obtain information on price, quality, delivery time, etc. Traditionally, economic theory has also dealt with the search problem. Search theory, as pioneered by Professor Stigler of the University of Chicago, postulates that the firm or individual searches until the additional benefits from continued search are equal to the additional costs. The additional benefits stem primarily from lower prices per unit or lower prices per quality unit and the additional costs arise from the foregone production or delays in delivery times to clients and the actual out-of-pocket expenses incurred for travel and other related expenses.

While it is difficult to argue that consumers or firms do not in fact engage in search, it is not likely, on the other hand, that the extent of search is as great either in terms of number of contacts made or geographic range in which the search is conducted

as is postulated by the theory. While price information may be readily available in many cases, other information, particularly for quality or future prices, is far from perfect and in many cases not available. Hence there is a high degree of uncertainty in the actual search experience of individuals. For this reason, most search is rather limited.

When we try to apply the search model to the behaviour of firms attempting to obtain non-public accounting services for example, there are several problems to consider. First of all, the locations of the accounting firms are not readily apparent to firms and/or individuals searching for accountants. In this respect, the accounting market is unlike consumer goods or producer goods markets. In these latter markets, firms identify their location by advertising. In the case of consumer goods, firms are generally situated in readily accessible and identifiable locations; in the case of producer goods, firms may use sales representatives to contact potential clients. Accounting firms, on the other hand, are not generally located in easily accessible or identifiable locations and are restricted in contacting prospective clients. More likely they are situated in upper levels of office buildings. In addition, the restraints on advertising further limit information on location and price.

Even after a client contacts an accountant, the only price information that may be made available will be an average hourly billing rate. Such a rate will be no more than an approximation for the cost of the services required. The services and time inputs required will be unknown unless some contractual arrangements

are actually undertaken and the parameters of the problems are better known to the accounting firm. Hence, what we observe is that information is much less readily available in the accounting industry and the price information that can be obtained is much more imperfect than it is in other types of markets (here we were referring to the traditional markets for consumer goods or jobs). Moreover, unlike the case, let us say, of a consumer good, where once the price is known, information is available on the complete price, in the case of accounting, information on the billing rate only will be available and this is entirely inadequate to estimate the total cost for obtaining a particular type of service. Consequently, if a prospective client is able to obtain price information from several firms, the client will still not be able to determine which firm will provide the particular service, ignoring the quality aspect, at the lowest possible price. The quality aspect presents another serious problem faced by clients in searching for an accounting firm. The quality problem is also important in the other types of markets and in most cases, information on quality is either non-existent or far from perfect and so a high degree of risk enters into the search model.

In the above discussion, we postulated that if a particular client selects the optimal quantity and quality of an accounting service, when the client searches for an accounting firm, information on quality is non-existent and the client can create only rather imperfect perceptions of quality. Variables such as size of firm, location of firm, billing rate charged by firm, designations of members of the firm, may be used as signals for measuring

quality. However, there is not likely to be any single or combination of variables that will be perfectly correlated with quality, although there in fact may be a strong correlation among some of these variables and some measure of quality. Quality itself is a rather imperfect variable to define and an imprecise variable to measure. As we suggested at the outset to this chapter, output in the accounting profession is difficult to define and measure and the problems are magnified several-fold in trying to define the quality component of the "output" of this industry. Thus, it is possible that clients searching for an accounting firm simply ignore quality and select on the basis of price only; however, they still face the problem that the average hourly billing rate and the total price for the service may not be positively related. In addition, search behaviour that ignores quality tends to be inconsistent with the profit maximization model of the firm. More realistically, some rough estimate of quality will be used and the firm will take into account the risk it may incur selecting an accounting firm with an uncertain measure of quality.

The discussion seems to suggest that the search for an accounting firm will be rather limited and most clients will tend to look for, or use, outside sources of information in order to assess the quality of a firm, as well as to obtain a better idea of the overall price that will be charged by a firm. Hence, search for an accounting firm may consist, first of all, of obtaining outside information from existing clients of various firms; from other

users of accounting services, such as financial institutions; or from friends, relatives, etc.[18] After some information is obtained from these sources, it is then likely that a client will select one, two, or at most a small number of accounting firms to contact, in order to obtain better information before selecting an accountant.

When we focus our attention on public accounting services, the search model becomes somewhat more complicated because at least in the case of auditing, the direct relationship between service and the profitability or attainment of some other objective for the firm becomes imprecise. There appear to be two reasons for demanding public accounting services: (1) to fulfill legal obligations; or (2) to obtain financing from outside sources. In the former case, it appears that since the firm is legally obligated to have an audit performed and that superficially such an audit will not improve the performance or the profitability of the firm, that the firm will try to obtain the lowest quality and/or lowest price service. However, since in most cases, the information provided by audits is primarily for the purpose of shareholders, the quality of the audit may have some impact on the relationship between the shareholders, the board of directors, and the management of the firm, and/or the price of the outstanding shares of the company. If the quality of the audit plays an important role in the assessment by the market of the share price of a company, then there may be an additional constraint on the firm's decision in hiring an auditor. Since it is common practice

for many companies to reimburse executives with stock option plans, there is an incentive on the part of the executives to try to optimize their income from stock options. Hence, there will be an incentive to improve the quality of auditing services up to the point at which the additional cost for further improvement will not be offset by further income gains from a higher valuation by the market of the prices of the shares of the company.

As for the constraint that may be imposed on the management by the need to satisfy the shareholders' desire for higher quality information, it is not obvious whether there is a strong incentive to try to trade-off quality for the price of the audit. If there are no key shareholders that can have a significant voice. in the operations of the company or the selection of the key management people, then there does not appear to be any strong reason why the firm will try to pay a higher price in order to increase the quality of the auditing services that they hire. More likely, the firm will have a stronger incentive to minimize quality and price. In the case where there is a key shareholder or group of shareholders, there may be greater pressures applied on the management of the company to optimize quality and pay less attention to the price of the auditing services. But here again, there is no model that has been developed that provides any strong insights into where the trade-off between price and quality lies. (See Chapter 1 for a further discussion of these matters.) One further point to consider is that auditing services may provide an additional source of information for management

that may assist in improving the efficiency of the administrative, co-ordination and financial functions of the management of the firm, and hence may play a role in increasing profits or the present value of the firm. If audits do provide a useful source of information for management, then it is conceivable that the quality of the service will once more play a key role in the selection process.

For non-audit reviews or audits that are performed to support demands for external sources of funds, there appears to be a good case for arguing that quality of service will be a factor in the selection process. If we consider this problem from the point of view of the lender, let us assume a bank, then the bank has three options available to it in considering the loan demand. First of all, the bank can incur costs to obtain financial and production information on the client. It can send out individuals to check the premises and go over the accounting records or it can hire some outside service or auditor to perform this task. If the bank selects this route, it can then pass on the cost of obtaining this information to the client in the form of a higher interest rate (a premium over the standard business lending rate). If the loan is rejected, then the bank can spread out the aggregate costs it will incur over the year in obtaining this type of information, over all business loans made. In effect, the average interest rates will include an allowance for the costs of obtaining information on prospective borrowers. A second possibility is that the bank

compels the firm demanding the loan to provide it with financial records that have been reviewed or audited by an external accounting firm. In this case, the costs incurred by firms receiving loans can be considered as a premium over the lending rate. If the loan is rejected, the costs reduce the profitability of the firm and may in fact jeopardize its viability. The third option is not to request any information. As a result of not obtaining any information the overall business lending rate will increase in order to include a higher risk premium. It is possible that the bank, for example, will use a combination of all three options.

If perfectly competitive markets exist, at least on the supply side of the banking industry, then we would expect the chartered banks to incur the costs directly, and perhaps build them into the lending rates. The reason for this is that if any bank demanded that the client incur the cost, another bank or other lending institution could compete by informing a prospective client that they would not have to incur the cost since it would hire an outside accounting firm or send its own people to obtain the information. The bank that would demand that the prospective client provide the information and incur the cost could counter by stating that the interest rate would be lower. However, from the point of view of the demander of the loan, the firm or individual would prefer spreading the costs of obtaining and providing this information over the term of the loan rather than incurring it in one lump sum without any guarantee of

obtaining the loan. The banking industry is not competitive in Canada. But the information obtained from the user interviews with the banks suggests that there is not as great an emphasis placed on audits as there is on non-audit reviews because of the differentials in cost and the recognition of possible competition among the banks.[19] If the lender were to incur the costs of obtaining information, it would likely hire firms providing a higher quality service if it were able to pass the cost on to borrowers in the form of higher interest rates. In light of the structure of the financial markets in Canada, if lending institutions do move in the direction of hiring the public accounting firm, they would likely opt for a higher quality, higher priced service, since they are in a position, given their market strength, to pass the cost on to their clients. In the situation where the lending institution demands that a prospective borrower provide them with information, the lending institution would tend to demand a higher quality service, since the cost is passed on directly to the prospective borrower. However, competition among financial institutions might result in a trade-off between quality and price in this particular case.

If we examine this problem from the point of view of the borrower, the firm is faced with the dilemma of hiring a public accounting firm to undertake an audit or non-audit review with no guarantee of obtaining a loan or if it does obtain a loan, obtaining it at a higher rate of interest.[20] A firm faced with trade-offs among the costs of having an audit or non-audit review

performed, the probability of having the loan demand accepted and the interest cost of the loan, might not opt to hire public accountants. If it did decide to hire a public accountant, it is difficult to determine what type of price-quality trade-off it would decide upon. If it believed that quality would have no bearing on the decision of the lending institution, obviously it would opt for the lowest possible price service. If, however, it believed that quality would improve the probability of obtaining the loan, then it might decide to pay a higher price in order to obtain a higher quality service. The decision would be tempered by the firm's perceptions of its own financial strength and future viability. If a firm believed that it was in a rather weak and precarious situation and the transfusion of funds might or might not prevent it from eventually failing then the firm would desire to minimize price and hence reduce the quality of public accounting services that it hired. A higher quality service could not improve the financial records or the operating figures. Higher quality services could only bring the poor performance of the company to light more quickly and more accurately. On the other hand, if the firm believed that it was in a strong financial position and that it had a high probability of succeeding in the future, then it might desire to hire a higher quality service in order to bring this type of information out and improve the chance of obtaining a loan.

What we can conclude at this stage is that the quality of other

public accounting services or auditing services that will be demanded in order to meet the requirements for obtaining a loan will depend to a large extent on the competitive structure of the financial markets and the relative bargaining positions of the lending institutions and prospective borrowers. The more oligopolistic the financial markets are and the greater the ability of lending institutions to directly pass on the cost to prospective borrowers, the more likely that the lending institutions will demand a higher quality service. Conversely, the more competitive the financial markets, the more likely that a higher proportion of the costs of obtaining information will be incurred by the lending institution and the demands placed upon prospective borrowers will result in trade-offs of lower prices for lower quality services.

After this rather long and inconclusive introduction, let us turn our attention to the information obtained from the various interviews with accounting firms, clients and third party users as they relate to the search process and the price-quality trade-off. To keep the various comments made in the interviews in perspective, it is important to note that there are at least four distinct groups of clients. First, there are those clients that are starting up new firms and as a result, the firm has no established track record and accounting records that can serve as a basis of information in support of loan demands with financial institutions. These types of firms are likely at first to demand the services of an accounting firm in order to prepare and keep the financial records in order as the firm develops (that is, a demand for

bookkeeping services) or to prepare statements for the Department of National Revenue (that is, corporate taxation services). There may not be any demand initially for public accounting services since the firm will not be obligated by statute to have an audit performed; nor will a review be required, unless the firm seeks significant outside financing immediately. As this type of firm expands, assuming it succeeds, it may outgrow the source of funds available to it (the principal shareholders and internally generated cash flows) and may require funding from financial institutions. In a case where funds were initially obtained from financial institutions, there may not necessarily be any requirement by the lending institution for further financial information. The behaviour and performance of the firm may be sufficient for supporting further loan demands. However, if the demand exceeds a certain level, then there may be a necessity for a non-audit review or perhaps an audit to be performed. At this stage, there is a demand for a specific public accounting service and this may entail a search for another accounting firm that is more acceptable to the financial institution.

A second type of client is one that has been in business for a certain period of time but has employed its own bookkeeper to prepare financial records necessary for the functioning of the company and for the Department of National Revenue. When the company reaches a stage where it requires outside sources of funds, it may be informed after approaching a lending institution, that it needs to have a non-audit review or audit performed.

In this particular case, the first contact of the firm with an accounting firm occurs when it demands public accounting services unlike the situation above where the first encounter occurred when non-public accounting services were demanded. A third type of client is one that has grown to the size where it is able to tap the equity and/or short term paper markets. In effect, it has access to a wider spectrum of the capital markets. A company that is interested in selling securities to the public must use the services of an investment banking firm and at the same time meet the obligations of a stock exchange in order to have its shares listed. If the firm had not been obligated to have audits performed in the past, it will now be so obligated. In addition, the selection of the auditor may be influenced by the investment banking firm or the stock exchange on which the shares are to be listed.

The fourth type of firm to consider is the large corporation, either domestically controlled or foreign controlled, that is well-established and has had auditing services provided for a period of time. Interestingly, members of the accounting profession generally argue that the auditing services provided for this group of firms are for the benefit of the shareholders; that is, the auditing firm owes its responsibilities to the shareholders and not to the management of the firm. However, it is the management of the company generally, that hires the auditing firm (in some cases there will be an auditing committee of the board of directors that has been established in order to hire the

auditors; however, it is likely that the decisions of management will have a strong influence on the ultimate decision of this auditing committee).

We learned from our interviews with the accounting firms that the "type one" clients that were interested in purchasing non-public accounting services most likely searched for small accounting firms. The second group, those with no previous experience with accounting firms, but who required public accounting services were likely to deal with accounting firms of all sizes. The third and fourth types of clients dealt primarily with the large public accounting firms.

There was a general agreement among all the accounting firms interviewed that very few new clients came in directly off the street. In cases where this happened, the clients were found to be unsophisticated and totally unaware of what public accounting was and what public accounting firms could provide in the range of services. Most new clients resulted from referrals by existing clients, friends or relatives of the client who also had contact or were indirectly related to the principals in the accounting firm. Referrals were also generally made, in the case of small clients, by lending institutions.

In many cases, particularly those in which non-public accounting services were demanded, the clients were in search of bookkeeping services only. In other situations, bookkeeping services were

the primary concern of the clients and taxation advice a secondary concern. As these types of clients expanded in size, but did not yet reach a stage where they required public accounting services, they next demanded management advisory services. In many situations, according to the accounting firms we interviewed, the services were provided either on the advice of the public accounting firm or as a natural outgrowth of the relationship between the client and the accounting firm. The demand for additional services rarely originated, as an independent request, from the client. Indeed, for small clients, after the initial advice and development of a record-keeping system, the primary demands were for "hand-holding" and day-to-day managerial and financial advice. A relation of trust developed over time between the client and the public accounting firm. According to the accounting firms, price appeared to be an important variable in terminating a relationship between clients and accounting firms. But dissatisfaction on the part of the client would more likely occur if the client believed that he was not receiving sufficient attention from the accountant.

The second category of clients that we discussed above would generally be referred to a particular public accounting firm by a lending institution or by another client of the firm. Here again there appeared to be a rather limited search by clients for public accounting firms. While the lending institution might have made a recommendation with regards to whether an audit or non-audit review would be preferred, the final decision as to which service would be provided, was generally determined by the accounting firm

in consultation with the client. On the basis of our interviews, it appeared that the small-to medium-size public accounting firms generally advised new clients that a non-audit review would be sufficient and that additional funds would be better spent on purchasing other non-public accounting services. The large public accounting firms were more in favour of performing audits than reviews because they viewed their role as an independent agent with an ultimate responsibility to third parties. Given the differences in quality between an audit and a non-audit review and the risks associated with performing both types of reviews, larger firms favoured the more precise and time-consuming audits which would continue to enhance the high profile and reputation of the firm. As their relationship with this group of clients continued, the public accounting firm again seemed to initiate demands for more services, particularly taxation and management advisory services. Indeed, for all public accounting firms interviewed, the primary source of growth was the expansion of their clients and the demand for a wider range of services.

As firms expanded in size, there was a tendency for them to outgrow their public accounting firms in one of two ways: either the range of services available to them and the extent of specialization by the CA's in the firm were no longer appropriate for the demands of the client, or, if the client desired to go public, investment underwriters, bankers, and other stock exchange officials strongly recommended the use of the services of a recognized national public accounting firm. When a switch was

made from a small-or medium-size firm to a medium or large size public accounting firm, the client was generally at a bargaining disadvantage, vis-à-vis the public accounting firm in terms of outlining the extent of the services, particularly auditing services, that were to be provided. The quality and auditing principles to be employed were largely determined by the public accounting firm. At this stage, the accounting firms viewed their role as a provider of information to third parties; namely, current and prospective shareholders. As a sub-set of this third category of firms, there is another group, created out of mergers. Mergers usually resulted in a change-over in accountants hired by one or both of the firms involved in the merger. Generally, the company that was taken over was compelled to hire the public accounting firm employed by the firm that initiated the merger or takeover. Initially, the public accounting functions were transferred and perhaps some of the non-public accounting functions were still performed by the original public accounting firm of the company taken over. However, over time the non-public accounting services would also be transferred to the new firm.

Finally, the overwhelming majority of the fourth category of firms, the large established corporations, were audited by the big eight national public accounting firms operating in Canada. Changes in public accounting firms by large corporate clients were usually the result of mergers or takeovers, either in Canada or elsewhere. If the merger occurred elsewhere, the parent company of the new operation generally required that the various operating subsidiaries

have their accounting records audited by the same public accounting firm as employed by the parent. This usually was to insure a uniformity in accounting principles employed. One final point as it relates to the largest group of clients is that, as economic conditions changed, there was generally a continual demand for development of new auditing principles that were more in line with the economic realities. In addition, specialty areas became more important to the large corporate clients as management and administrative techniques altered as a result of dramatic changes in computer technology.

Large public accounting firms tend to be at a competitive advantage vis-à-vis the smaller public accounting firms in attracting new clients because of their involvement in institute affairs, their involvement in social and charitable activities, and their generally higher profile, both in the accounting profession and in the business community. In addition, the financial industry referral system (brokerage firms, banks, etc.) tends to favour the large firms. The principal disadvantages of large firms vis-à-vis the smaller- and medium-size firms are the perceived higher prices of the large public accounting firms and the perceived lower degree of attention paid to the affairs of their clients by such firms. There does appear to be some implicit trade-off made between price and quality by small clients since there tends to be a recognition, both within the accounting profession and outside the profession (particularly in the financial community) that the quality of services does increase

in line with the size of the public accounting firm and with the degree of specialization and diversity of services provided by a firm.

Overall there appears to be a rather limited search by clients for public accounting firms and generally once an attachment is made, the demand for new services arises more from the continued development of the engagement and the increased familiarity of the accounting firm with the problems encountered by its clients. Rarely does the demand for additional services originate with the client independent of the accounting firm hired. As an official of one accounting firm pointed out to us, once you go beyond the sole proprietorship, most accounting firms provide a wide range of services and clients tend to be locked in with the public accounting firm in hiring these additional services. Finally, despite the notion that all public accounting firms are nominally independent of the clients that hire them, at least in the provision of public accounting services, the small-and medium-size public accounting firms viewed their primary responsibility to be to their clients and secondly to third party users. As one individual told us, satisfying the client becomes the principal objective because the client pays the fees. As a result, close relationships do develop between client and public accounting firm and from these relationships, a wide variety of services ensue. The development of this type of association obviously imposes some constraints on the whole concept of independence between client and firm. On the other hand, there appears to be unanimity on the contention that the

large public accounting firms are entirely independent of the clients.

We now turn to some of the information obtained in the client surveys.[21] The information obtained from the clients seems to corroborate the information obtained from the accounting firms. For example, the data presented in Table 24 suggests that small clients (for the purpose of the client surveys, small clients were defined as ones with sales of less than $250,000) tended to employ public accounting firms with fewer than ten partners. Medium-size clients (for the purpose of the survey they were defined as firms having sales between $0.25 and $1 million) were more likely to employ medium-size accounting firms than were the smaller clients. Finally, the large clients (for the purpose of the client survey, they were defined as clients with sales in excess of $1 million) were more likely to employ medium-and large-size accounting firms. This type of relationship between size of client and size of accounting firm seems to suggest that the smaller firms do tend to make a trade-off between price and quality and have the perception that larger public accounting firms charge higher prices. In addition, the data in Table 24 also suggest that medium and large clients were more likely to require the services of a public accounting firm in order to meet statutory obligations or the demands of a potential lender and hence, were less likely to trade-off perceived quality for perceived price.

TABLE 24

Distribution of Accounting firms of Business
Clients of Different Size, by Number of Partners in Firm

Number of Partners in Accounting Firm	Clients Small	Medium	Large
1	34.8%	12.5%	11.8%
2 - 9	52.2%	70.8%	35.3%
10+	4.3%	16.7%	50.0%
No response	8.7%	-	2.9%
Number of clients	23	25	34
Average sales of clients	$56,000	$430,000	$5,750,000

This might be especially pronounced in the cases where the client is at a bargaining disadvantage vis-à-vis the lending institution.

As expected, the results of the client survey pointed out that a much higher proportion of small firms used the same public accounting firm for less than ten years than was the case with the large firms. According to the results of this survey, about 83% of the small clients had used the same public accountant for less than ten years, whereas for the large firms, the proportion was only 53%. Furthermore, small clients were more likely to be new firms and as a result, the public accounting firm that they were currently using was likely to have been a new choice rather than a switch from another public accounting firm. Larger firms,on the other hand, were more likely to have been in business for a longer period of time and thus, for the ones that had used the current public accountant for less than ten years, there likely had been a switch from one firm to another. In most cases when a new public accounting firm was selected, the choice was rarely made from among a range of firms. Only in the case of the large clients was there any significant use of a range of firms in the selection process. However, even for this type of business firm, rarely was more than one public accounting firm contacted. Thus, the above information suggests that there is indeed limited search for a public accounting firm.

Data in Table 25 tend to give some indication of the importance of different sources of information. For small clients, the

Table 25

Distribution of Source of Information of New Accountant Firm by Clients of Different Size

	Clients		
Source of Information	Small	Medium	Large
1. Referred by, or is a friend	20.0%	46.7	22.2
2. Recommended by a banker, lawyer or business colleague	50.0	20.0	27.8
3. Parent company or subsidiary	15.0	26.7	38.9
4. Other	15.0	6.7	11.1
Number of Clients	20	15	18

primary sources of information were recommendations by a banker, lawyer or business colleague. In the case of medium-size business firms, referrals by friends or personal contact with the public accountant were the primary sources of information. In the case of large clients, the parent company played an important role in influencing the selection of a public accounting firm. Overall, external sources, if we include parent companies as external sources, were the principal sources of information about public accounting firms. Hence, the selection of a public accounting firm was not based, despite the limited search, on a total lack of information. The quality of the information obviously differs depending upon the source and the ability of the source to discriminate in terms of quality among different public accounting firms. Nevertheless, clients in selecting firms did have information available to them; information that would be superior to that obtained from a direct contact of a public accounting firm, given the various uncertainties and imperfections of the information desired. As Ms. Myers reports in her client survey report, "Most of the respondents thought they had adequate information available to them about accounting firms. This was specially felt by the small and large companies."

Among the business clients that switched accountants, the primary reason cited, at least among the small-and medium-size clients, was dissatisfaction with the service or problems that arose in dealing with the accountant. The second most cited reason for switching accountants was either the expansion of the client firm or

dissatisfaction with the size of the accounting firm and range of services provided. This argument would seem to support the previous observations made by accounting firms that as a client grew, it would simply outgrow the ability of its public accounting firm to meet the increasing range of services required by the firm and the demands of outside creditors.

Another interesting source of information derived from the client interviews concerned the annual re-hiring decision. As would be expected, given the limited search for public accounting firms by small-and medium-size clients, the decision to re-hire a public accountant was in most cases automatic. For 78% of the small clients, and for two-thirds of the medium clients, the decision was automatic. The decision was automatic for only 23.5% of the large clients. In the cases where the decision was not automatic, it generally required the approval of shareholders or directors. In the case where the approval of shareholders or directors was required, generally the approval was a simple formality. Only in the case of the large clients was a review procedure employed on a seemingly regular basis. For 41% of the large clients, a review procedure was common practice. Thus, we tend to find that not only is there a limited search for public accountants, but once a public accountant is hired, the search process tends to automatically terminate.

We examine in Table 26 the principal reasons why business clients purchased audits. First of all, we note that the proportion of

Table 26

Distribution of Reasons for Purchasing
Audits, by Clients of Different Size

	Clients		
	Small	Medium	Large
Proportion that purchase audits (number)	26.1%(6)	75.0(18)	85.3(29)
Reasons for purchasing audits:			
1. Required by statute	66.7%[A]	38.9	62.1
2. For internal use	50.0	72.2	57.9
3. For bank or other lending institution	-	44.4	31.0
4. For government tax authorities	16.7	5.6	3.5
5. Don't know	-	5.6	3.5
6. Other	16.7	5.6	13.7

Notes: A - Proportion of clients that have audits; therefore, proportions do not sum to 100% for any client category.

clients that purchased audits increases with the size of the client. For example, only 26% of small clients purchased audits, while 85% of large clients did so. Surprisingly, a key reason given by clients in all three size categories for the purchase of audits was the need for internal use of the information provided. The importance of this reason would suggest that quality of service would indeed be a key factor to be considered in selecting the public accounting firm, and purchasing auditing services. For the small and large clients, the principal reason for purchasing audit services was a statutory obligation. For medium-and large-size firms, another important reason was the demand of banks or other lending institutions. Surprisingly, for none of the small clients was an audit required by a bank or other lending institution. It would appear that in this case, since audits were already being performed, that the banks or other lending institutions would simply rely upon the audits and not impose any additional demands upon the small clients. In the cases where the audits were not required by statute, the banks or other lending institutions were more likely to demand a non-audit review in order to minimize the costs (for the client) of obtaining and providing the information to the lending institution.

Focusing on non-audit reviews (Table 27), we find that the smaller the client, the larger the proportion of such clients that purchased these reviews. In addition, the principal reasons for purchasing such reviews were the demands placed upon a client by

Table 27

Distribution of Reasons for Purchasing
Non-Audit Reviews, by Clients of Different Size

	Clients		
	Small	Medium	Large
Proportion that purchase Non-audit reviews (number)	39.1%(9)	29.2(7)	20.6(7)
Reasons:			
1. For internal use	55.6%[A]	42.9	28.7
2. For bank or other lending institution	55.6	85.7	71.4
3. Tax reasons	44.4	28.7	-
4. For other users	-	14.3	42.9
5. Other	-	14.3	-

Notes: A - See Table 26.

banks or other lending institutions. As in the case of audits, a rather large proportion of the clients pointed out that the non-audit reviews were purchased for internal use as well. This again would seem to suggest that quality would be an important factor and would not be entirely minimized.

In addition to the public accounting services, most of respondents to the client survey pointed out that they also purchased other non-public accounting services, either from the same public accounting firm or from other sources. Of the non-public accounting services most commonly in demand, taxation stood at the top of the list. Generally, taxation services were purchased from the same public accounting firm, although in some cases, particularly in medium-and large-size business firms, taxation services were purchased from lawyers or outside consulting services. The rather strong demand for taxation services would tend to be in line with our earlier statements that in many cases the initial contact between a client and a public accountant arose from a need to obtain tax advice and prepare statements for the Department of National Revenue. The second most common non-public accounting service in demand was bookkeeping. In most cases, an independent bookkeeper rather than the public accounting firm was hired by the client. This was quite prevalent among the medium and large clients but less so among the small clients. Following bookkeeping came the purchase of management accounting and consulting services. Small-and medium-size clients relied entirely upon the public accounting firm for these services, while larger

firms were more likely to use other public accounting firms or outside management consulting companies for these services. In the case of taxation, bookkeeping and management advisory services, large firms also relied heavily upon their internal accounting offices. Small-and medium-size firms either did not have any such internal accounting office or, in cases where ones existed, were not likely to rely on them to any considerable extent. Estate planning, AIB compliance advice and advice on Canada Pension Plan, UIC, Workmen's Compensation benefits were also cited among the other services demanded by clients. However, a rather small proportion of the clients demanded these other types of services.

In general, it appears that the small-and medium-size clients are locked in, to a certain degree, to their public accounting firm in purchasing non-public accounting services. Larger clients, despite their limited search among public accounting firms for the purchase of public accounting services, are likely to search more widely for the purchase of non-public accounting services. Yet even for this group of clients, the range of search is still rather limited. Finally, with regard to the purchase of non-public accounting services, most clients admitted that they could have purchased these services from other than a public accounting firm. But very few bothered to explore for alternatives before selecting their public accounting firm. The primary reasons given by the clients for not exploring alternative sources was the expertise of the accountants. This reason was cited in about half the cases. Two other important reasons were the familiarity with

the accountant and the credibility of the accounting designation of their accountants. The importance attached to these various reasons would suggest that clients are concerned about quality of service and do relate quality to accounting designation.

While the overall perception that we have obtained from the interviews with accounting firms and clients suggests that there is limited search and consequently limited price and quality information, nevertheless, there does appear to be information available about these two dimensions and the clients do tend to be concerned about quality in setting their selection criteria. The larger clients appear to be better informed about quality, but even the smaller clients, given the importance of recommendations by bankers and other lenders, are generally inclined towards public accounting firms which in the eyes of the financial community are likely to provide a higher quality and/or more credible service.

Information obtained from the users' interviews, particularly with officials in the major chartered banks, also provided some rather useful insights into the client-firm selection process and into the underlying motives for demanding public accounting services. All five bank officials interviewed agreed that no large loan could be made without audited financial statements. Generally, loans in excess of a million dollars would require audited statements before they would be considered. Loans below one hundred thousand dollars would not need to be accompanied by audited statements.

One of the respondents also stated that he was reluctant to insist upon an audit for small customers because of the price factor and pointed out that competition among the chartered banks for the business of his client would likely result in at least one other bank not requiring an audited statement to accompany the demand for a loan. Thus, although banking officials appeared to demand an audit or at least a non-audit review in support of the documents for a loan demand, they did take into account the ability of potential borrowers to pay and the quality differences between audits and non-audit reviews in making their recommendations to potential customers. Furthermore, the banking officials emphasized that the statements were generally part of a package of information that was required in order either to approve or disapprove of a loan. Hence, although quality was important, it was not always an overriding factor directing prospective borrowers towards a particular public accounting firm.

Section III: Price and Quality

From the discussion in Section II, it would appear that clients are aware of quality differences and theoretical arguments can be developed to suggest that quality minimization is not necessarily consistent with profit maximization by the firm. Clients will likely trade-off price and quality to some extent; however, given the imperfections in the information available, it is important to consider the extent of the trade-off actually made, and the

accuracy of the clients' perceptions of quality.

However, as we have mentioned at several points thus far, quality is a difficult characteristic to define, particularly in an industry in which a quantitative measure of output is also difficult to define. Before we consider the various sources of inferential information bearing on quality, the concept of quality, inter-firm quality differences and the importance of quality in the decision of clients, we will make some brief introductory comments.

In the area of non-public accounting services, we can theoretically define quality or compare the quality of services provided by different firms in the following manner: if a given service is provided, for example, advice on a particular tax matter, at the same cost by two accounting firms, then the firm that saves the client the largest sum of money is providing a higher quality service. In this particular example, there is a greater savings to a client for a given dollar outlay and hence the marginal benefits to the client are greater from one accountant than they are from the other for the same marginal cost. We should add the qualification that, in terms of saving the client money (reducing the tax obligations), we are assuming the advice takes the form of using only legal tax loopholes (the accounting firm is simply using existing tax legislation to the maximum advantage of its clients).

For the example that we have selected, one can counter that if all accounting firms provide the optimum quality, as defined above, then there will be a decrease in tax revenues generated by users of public accounting services and hence one of two results will follow:

(1) there will be a redistribution of income from the non-users of public accounting services to the users of public accounting services; or

(2) there will arise a need for the government to increase tax revenues from other sources. In the former case, this redistribution may lead to a greater demand for accounting services in order to minimize the redistribution effect; however, this will result in a further decrease in the revenues available to the government and thus, perhaps, an across the board income tax surcharge to compensate for these lost revenues. Obviously then, in a perfectly competitive system, there will not likely be any net advantage to all clients from a higher quality service since the government, in trying to offset the lower tax revenues resulting from a high quality accounting service, will simply increase tax rates. There is the possibility that the lower tax revenue may lead to a lower level of government spending but this will have another distribution impact on the economy. Or, the government deficit may be financed by borrowing from the public with the consequent squeezing out effects. There may also be an expansion of the money supply to finance the deficit, but this will have an inflationary impact. Thus, the principal advantage of a higher quality tax advice, in the short run, appears to be the

redistributional aspect and the inability by some clients to afford the highest quality service.

If we take the example of management advisory services, here we can define quality in terms of the additional revenues or the cost savings generated by advice from different firms for the same cost. Obviously, the firm that increases its clients' revenues or reduce their costs by the largest amount, for a given dollar outlay, will have provided the highest quality service. In this situation, higher quality management advisory services will in fact improve the efficiency of the economy by enabling a higher level of production for a given level of inputs and will lead to a potential expansion in aggregate social welfare. The firms that obtain the high quality service will have a competitive advantage that may become institutionalized in the long run if one takes into account the relationship between profits, investment potential, growth and the creation of longer term barriers to entry. Nevertheless, in this particular situation, there is a dramatic impact on the performance of the economy that may result from a higher quality service.

In the realm of public accounting services we encounter more serious difficulties in attempting to measure quality and, as well, difficulties in trying to determine what the effect will be on the performance of the economy of a higher quality service. With lending credibility to financial statements being the avowed output of public accounting, we must seriously question what higher

quality credibility is and what difference it will make to the overall performance of the economic system. Let us consider the case of an audit being performed for statutory purposes. It is conceivable in comparing two firms providing an audit for the same cost, time input, etc., that if only one firm discovers, in the process of its audit, that the most advanced accounting principles were not employed and hence as a result, the corporate tax obligations were overestimated, then it is possible to argue that in one case the auditing services were of a higher quality. However, what relationship does this have with a higher degree of credibility of the data?

It is possible to argue that the data better reflect the true performance of the firm and provide a better estimate of the assets and liabilities of the firm. However, in this situation, the impact on the overall economic performance of reducing the corporate tax liabilities are analogous to the results of a higher quality corporate taxation service. At the aggregate level, it will be difficult to assess the net effect on the economy. But ignoring the equilibrium results that may occur if other clients recognized differences in quality, it is possible, again using this example, that as a result of the lower tax liabilities and increased after-tax profitability of the firm, the stock market may assign a higher price-earnings ratio to the equity of the company and that this, in turn, will make it easier for the firm to attract financial capital by issuing new equity. Consequently, using this partial equilibrium analysis, there will be a more efficient

allocation of funds in the market with a more profitable and efficient firm receiving a larger share of the funds available, or the same share at a lower cost. Thus, it is conceivable that the efficiency of the economy may be improved from the provision of a higher quality auditing service, at least in the example that we have provided.

Even allowing for the fact that the tax advantages are basically a redistribution of income there still may occur the allocative efficiency improvement. However, even though there may be a relationship between quality and improved allocative efficiency this does not imply that the optimal quality level of the service will be the maximum level of quality attainable. The additional benefits, in terms of improved allocative efficiency, are likely to be offset by the higher resource costs incurred in improving the quality of service.

Let us now consider another possibility. In this case, auditing services are required because the client is requesting a loan from a chartered bank. From a micro-perspective, a higher quality service will be one that, ceteris paribus, uncovers certain flaws in accounting principles used that resulted in an inappropriately low risk premium being attached to loans to this firm. Once more, allocative efficiency may be improved by the provision of a higher quality service. Thus, there appears to be a case that can be made for defining quality of public accounting services in terms of the impact of the service on the allocative

efficiency of the economy and the longer term growth of the economy. In the examples that we have considered, a more efficient distribution of funds among potential borrowers may result in a better use of these funds and a higher rate of growth for the economy. However, it is not always true that past performance is a good predictor of future performance. Consequently, because of this particular uncertainty, the longer term allocative efficiency of the economy may in fact not be improved by a higher quality public accounting service being provided in the manner discussed above.

Thus, we reach the paradoxical situation that in a static framework, using past performance as a predictor of future performance, it is theoretically possible to develop a case in which a higher quality service may improve the performance of the economy. Yet, the only way we can measure quality in this particular case is by the *ex post* impact the service has on a client and on the economy -- in the case of the client, the stock market's assessment of the value of the firm or the financial community's assessment of the viability of the firm. We are not able to determine *ex ante* a means for measuring the quality of service. This should not be surprising in light of the difficulties of measuring output in the accounting industry.

Another aspect that must be considered in the analysis is the importance of quality to the overall performance of the economy and as well in the decision-making process of the client. Let

us consider two events -- X and Y -- events that differ in terms of risk. Event X has a narrower range of possible outcomes than event Y. Moreover, each of the discrete number of outcomes has the same probability of occurring in the absence of the purchase of outside public accounting services. By purchasing public accounting services, the probability of unfavourable outcomes occurring declines, the rate of decline being directly proportional to the quality of the service. In other words, the higher the quality of service, the greater the probability of the more favourable outcomes occurring and the less likely that the less favourable outcomes will occur. To simplify the discussion further, we can assume that there are ten initial outcomes for both events and that for each additional unit of quality, the probability of the most favourable outcome increases by the same Z per cent for both events X and Y.

If the dispersion in the case of event X amounts to, let us assume, $100 and the range for event Y amounts to $1 million, it is obvious that the monetary gains from an improvement in the quality of the service in the case of event X are rather insignificant while in the case of event Y they will be rather substantial. Thus, taking into account the cost of the resources used in providing a higher quality service, which must in turn be reflected in the cost of obtaining these services, it is obvious that in less risky events, defined here as those with a narrower range of outcomes, there may actually be a detrimental economic impact associated with a high quality service. That is, the marginal

costs of the higher quality service may exceed the marginal benefits. In the case of more risky events, the marginal benefits resulting from a higher quality service may exceed the marginal cost of this service for some positive values of quality of service.

As the above example was intended to demonstrate, it is not a simple matter to determine what the optimal level of quality for a public accounting service should be. In addition, given the problems in measuring risks, that is, determining the possible range of outcomes and assessing the probabilities of the various outcomes in the absence of public accounting services, and the additional problems associated with measuring the effect of different quality services on the probabilities of the various outcomes, the problem of selecting the optimal quality level becomes even more pronounced.

There also remain problems associated with incorrect perceptions on the part of clients of the actual quality of the service provided by various public accounting firms. Since, as we have already stated, there are no objective criteria that can be used to measure quality, rules of thumb must be used. The development and application of these rules of thumb by different clients is most likely to result in different degrees of accuracy in the measurement of quality. As a result, the whole concept of quality becomes a rather tricky issue to deal with, both theoretically and empirically.

Once more, following a rather lengthy introduction, we turn our attention to the information we have obtained from the various interviews and surveys. Our initial concern in this section will be the setting of price in the accounting industry. More specifically, are the larger firms higher cost firms, both in terms of average hourly billing rates and overall billing fees for a particular type of engagement? Furthermore, if they are higher cost firms, do these higher costs reflect higher quality services and hence on a dollar per quality basis is there any difference in the rate charged by accounting firms of different size?

In order to test, to a degree, these hypotheses, we estimated linear equations relating the average hourly billing rate for accountants with only a CA designation and more than ten years of experience[22] to the number of CA's in the firm, the postal code dummy, an international affiliate dummy, the percentage of fees derived from auditing, the percentage of fees derived in the fee category $50,000 and over and average number of non-CA employees per CA (AVEMP in Table 28).[23] The auditing variable was included in order to test whether the higher risks facing an accounting firm when it performs an audit are reflected in the average hourly billing rates charged by the firm. The large fee category variable was included to measure whether the bargaining between large clients and public accounting firms resulted in an advantage for the client or for the firm. The regression results are reported in Table 28.

Table 28

Multivariate Regression Results Using Average Hourly Billing Rate for CAs Who Have Had Their Accounting Designation for More Than 10 Years As The Dependent Variable

Dependent Variable	Independent Variables							Selected Statistics				
	Constant	CA7	POSTDUM	AFFINT	PCFEEAUD	PTOTFEE4	AVEMP	R^2	F	MEAN	SEE	NOBS
CAIAR	37.58	0.109 (2.50)	7.05 (4.70)	-10.54 (- 2.49)	0.029 (0.82)			0.14	14.75	33.44	12.86	336
	36.16	0.111 (2.56)	7.17 (4.83)	-10.49 (- 2.51)	0.017 (0.48)		1.71 (2.83)	0.16	13.65	33.44	12.73	336
	37.59	0.110 (2.48)	7.05 (4.69)	-10.55 (- 2.49)	0.029 (0.82)	-0.018 (-0.15)		0.14	11.77	33.44	12.88	336
	36.16	0.111 (2.51)	7.17 (4.82)	-10.49 (- 2.50)	0.017 (0.48)	0.001 (0.00)	1.71 (2.82)	0.16	11.34	33.44	12.75	336

Means

CA7	4.65
POSTDUM	0.66
AFFINT	0.96
PCFEEAUD	28.70
PTOTFEE4	0.61
AVEMP	0.95

Keeping in mind that there were only 336 usable observations, we find a positive correlation between average hourly billing rate and the number of CA's. For example, in all cases, the estimated coefficient for the CA variable suggests that for every ten additional CA's in the firm, the average hourly billing rate rises by about one dollar or 3% of the average hourly billing rate. In addition, firms located in the greater Metropolitan Toronto area tend to charge an average hourly billing rate approximately $7 higher than the firms operating outside this region. This price differential may reflect the higher costs of living in the greater Metropolitan Toronto area or perhaps may reflect the fact that clients tend to be somewhat larger on average in the greater Metropolitan Toronto area and so have a greater ability to pay than clients outside this region. These results suggest that despite the apparently lower levels of competition in the regions outside the greater Metropolitan Toronto area, other factors are generating lower billing rates in these regions of Ontario. Furthermore, public accounting firms with international affiliates also appear to charge an average hourly billing rate of approximately $10.50 per hour greater than those firms without international affiliates. It is possible that the international affiliation dummy variable indirectly represents a higher quality service. By having such affiliates, these firms have access to the accounting and auditing research performed by the affiliates and might in turn have access to specialists in a wide range of accounting services that are employed by these affiliates.

The two fee variables entered into the regressions with insignificant coefficients, and, as expected, the average hourly billing rate tends to be positively related to the average number of non-CA employees per CA. The rationale for this relationship is that the greater the quantity of other inputs used in the production of accounting services, the greater should be the productivity of the CA input.

The results presented in Table 28, while supporting the positive correlation between average hourly billing rates and size of firm, suggest that if we do not compare the extremes in terms of size of public accounting firms, but rather compare average hourly billing rates for firms of marginally different size, we find a rather small difference in the average hourly billing rates. For example, if one compares the average hourly billing rates, ceteris paribus, of a firm with five CA's to that of a firm with ten CA's, the difference amounts to about $0.50 per hour. This implies that there may be a spill-over effect from the price leaders in the industry, namely, the largest firms, to the next largest group of firms, and that in turn, there is a further spill-over effect from the second tier group of firms to the next largest group of firms and so on and so on. In other words, firms in a particular size category tend to use the fees charged by firms somewhat larger as a guide for the fees that they should be setting. Consequently, a modified price leadership type of model appears to describe the price setting behaviour of firms in the accounting industry.

Our discussion with the various accounting firms supported this price leadership hypothesis. It was generally stated that the prices paid for students and newly designated CA's, as well as for CA's with a few years of experience, were basically established by the big eight. Smaller firms would modify the rates they would charge on the basis of the size and ability to pay of their clients. Obviously, the salaries of CA's, with a larger number of years of experience, in all firms would be related to the rates paid to students and newly designated CA's. Hence, the entire hierarchy of average hourly billing rates would be established to a considerable degree by the big eight, but modified to meet the different circumstances faced by the various public accounting firms.

The average hourly billing rate was assumed to be a guide for determining the overall fee that would be charged to a particular client for a particular type of service. But each public accounting firm has a rather wide degree of latitude in setting the final fee. There is flexibility with regards to determining the actual amount of time spent in providing the service as well as in determining the desired recovery rate from a firm. We tended to hear repeatedly that for a similar amount of time input, the total accounting fees would be lower for new clients or less established clients than for larger or more established clients. In effect, the public accounting firms were making an investment in their clients. That is, in order to improve their clients chances of succeeding, the fees charged for the provision of public accounting or non-

public accounting services would generally be well below the fees that should be charged, using an average recovery rate and allowing for the actual time input. The rationale was that if the full fee were charged it might prove to be too great a financial burden for some clients and that consequently the actual fee that would be paid would be much lower than what in fact was charged. In addition, the public accounting firms generally assumed that by undertaking this investment in their client, they would be able to develop trust and confidence with their client and so establish a longer-lasting relationship with the client. As a result, as the profitability of the client improved, the fee charged could rise more than proportionately to the actual time devoted to providing the service for the clients.

While this type of pricing strategy would appear to be efficient from an economic point of view, since the public accounting firm is absorbing the risks associated with failure on the part of its clients and the accounting firm is better able to spread the risks over its clients and obtain funds in the capital market to finance the investment in these risks, there remains the question whether, in situations in which the probability of failure is perceived to be quite high by the public accounting firm, the firm does in fact provide the highest quality services possible given the undercharging of such clients. For example, if the actual fees are claimed to be $1,000 but the client is charged only $700, did the public accounting firm in fact provide $1,000 worth of services? Obviously, if the quality or quantity of service is more in line with the

actual fee charged rather than with what the claimed fee is, and since the accounting firm establishes the actual quantity/quality mix of service, it might in fact be providing a lower quality service to small firms and hence increasing the likelihood of failure; we can neither confirm nor refute this hypothesis with the data in this report, however.

Leaving this question aside and returning to our survey and interview data, we found that the actual hourly billing rate was viewed by most of the accounting firms interviewed to be inconsequential in the fee negotiations with clients. In several cases, the accounting firms expressed the desire to arrange an open-ended engagement in which the average hourly billing rate was established beforehand, but the final fee would be determined on the basis of the actual time devoted to providing the service. In these cases, however, there was some general discussion about the maximum possible fee for the engagement and generally this maximum served as a constraint on the actual time input devoted to the particular accounting function as well as a constraint on the ultimate fee charged. In other cases, the total fee was negotiated beforehand with a proviso added that in case unforeseen problems were encountered, the fee would be re-negotiated. In either case -- both the open-ended fee arrangements and the pre-negotiated fee cases -- the ability to pay of the client was taken into account by the accounting firm in setting or negotiating the final fee. The ability to pay was to a large extent predicated on the profitability of the firm. From our discussions on fee negotiations, we derived the impression that the accounting firm

possessed a large degree of discretion in determining the actual quantity and quality of services to be provided to the client. Indeed, if during the process of performing a public accounting service, the accounting firm saw the need of providing some ancillary non-public accounting service such as management advice, corporate taxation advice, etc., it generally proceeded to advise the client of the need for these additional services and since they were usually in a better position to evaluate the need for such services, in many cases the public accounting firm was able to persuade the client of the need to purchase additional services.

In light of the discretion available to the public accounting firms in selecting the mix of people to be involved in servicing a particular client or providing a particular type of service to a client, we found it important to question the public accounting firms on how they made these decisions. The general impression we derived from our discussion was that the more routine procedures, such as data checking and data gathering, were performed by the more junior individuals in the firm; in the case of medium to large firms, students, and in the case of smaller firms, students and paraprofessionals. A large part of the "number-crunching" of other public accounting and auditing work was performed by the more junior or the less experienced individuals in the firm. In comparing the mix of people among public accounting firms of different size, we discovered that there was a greater likelihood of a partner or a more experienced individual, probably a CA, performing an audit or the more routine aspects of an audit or

other public accounting engagement in a small firm than would be the case in a medium to large size firm. Obviously, if experience is correlated with quality, we might question whether the quality of service provided by large firms is indeed commensurate with the billing rates charged by these firms and whether in fact, the quality provided by these firms correlates with perceptions of the public of the quality of service provided by large public accounting firms? The answer, of course, depends upon how effectively the senior people supervise their juniors.

In all firms, the more senior people -- the partners and/or CA's with multiple designations or degrees and several years of experience -- were engaged in providing specialized services such as management or corporate taxation advice or the more highly sophisticated aspects of auditing. In comparing small and large firms, we found that there was a higher degree of specialization in the larger firms than in the smaller firms. The degree of expertise was more varied among the senior people in smaller firms. In the larger firms, while the degree of expertise was narrower, it was also much more highly developed among the senior people. In addition, in the larger firms the more junior people do have access to the specialists and are able to call upon them to provide "high quality" advice when unusual problems are encountered. This fact suggests that in large firms, even when students or junior personnel are assigned to performing the bulk of public accounting services, the quality of the service is as high, if not higher, than the service provided by the senior personnel in smaller accounting firms. On the other hand, the greater turnover of the

more junior staff, in comparison to the much lower turnover of the middle to senior staff of smaller firms, suggests that because of the greater continuity of association between client and accountant in a smaller firm, vis-à-vis the larger firm, there might be an off-setting factor to the accessibility of specialists within the larger firms. However, while in most cases, small clients required basic or routine services, the need for specialists, while infrequent in the case of small clients, is probably more important in terms of the long-term success and viability of such clients than is the case for large clients. Large clients generally have an internal accounting department established and the managers are able to call upon their personnel to deal with specialized problems of a highly sophisticated nature. Thus, in attempting to assess quality differences in the services provided to small clients by accounting firms of different size, there are many offsetting factors that enter into the picture and again, it is difficult to reach a definitive conclusion.

To shed some further light on this question of quality of service, we present some data in Table 29 on the deployment of personnel in the various accounting firms. The source for these data was the accounting firm surveys. The larger the firm in which the student is employed, the much larger proportion of his time is spent in performing audits and other public accounting services.
For example, in sole proprietorships, only 10% of the student's time is devoted to auditing activities, while about 84% of his time is devoted to such activities in the big five firms that responded.

Table 29

Percentage of Total Chargeable Time of Different Categories of CAs spent in Auditing or Other Public Accounting Activities, by CA Firms of Different Size

Number of CAs in Firm	CA Category							
	A		B		C		D	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
1	31.7%	52.0	16.1	35.1	11.5	47.7	10.2	10.8
2	31.9	45.5	21.0	41.0	30.5	40.6	36.1	4.4
3	33.6	40.0	24.5	29.8	31.2	40.3	31.7	29.6
4-5	32.0	35.3	35.3	33.2	42.7	37.3	51.0	33.7
6-10	28.5	35.2	33.9	26.7	49.3	29.3	47.9	31.8
26-150	74.0	3.5	58.3	3.5	68.7	6.5	79.3	6.0
151+	60.4	3.5	69.0	4.2	79.0	6.8	84.4	8.5

Notes:

A - Individuals who have/had held a CA designation for more than 10 years.
B - Individuals who have/had held a CA designation for 6 to 10 years.
C - Individuals who have/had held a CA designation for less than 6 years.
D - Students in a CA program.
1 - Proportion of chargeable time spent on auditing.
2 - Proportion of chargeable time spent on other public accounting.

Obviously, students get a much better background and training in the public accounting area in the larger firms than they do in the smaller firms. Thus, not only do the students hired by the large firms appear to have an ability advantage initially,[24] but this advantage is magnified in terms of public accounting experience and knowledge.[25]

Once we move beyond firms with three or four CA's, we find that a smaller proportion of the accountant's time is devoted to auditing, the greater the number of years that the accountant has had his CA designation. For example, in firms of four to five CA's, accountants who have had their designation for less than six years spend, on average, 43% of their time in auditing work, while those who have had their designation for ten or more years spend only 32% of their time in auditing. This supports the earlier argument that the more senior and more experienced individuals are likely to spend a larger proportion of their time in more specialized activities. In the three smallest firm size categories, there does not appear to be any direct relationship between years of experience and time spent on auditing.

Another comparison worth noting is that in the three smallest firm size categories, the proportion of an accountant's time spent in providing other public accounting services exceeds for all levels of experience the proportion of time spent in the provision of auditing services. For the two largest firm size categories, a rather small proportion of an accountant's time is spent doing

other public accounting work. Considering the differences in the standards of performing an audit and a non-audit review or non-review, and considering the extent of specialization in the provision of auditing in the larger firms vis-à-vis the smaller firms, it would appear that the quality of service in performing audits is likely to be much higher in the larger firms than in the smaller firms. There could be, though, an off-setting factor in terms of differences in the mix of employees performing the various functions.

We will now examine the perceptions of clients as they relate to quality differences. The data in Table 30 demonstrate that just a bare majority of the clients feel that they are able to detect differences in the credibility of financial statements audited by public accounting firms of different size. Even among the large clients, whom we assume to be more sophisticated, about 45% of the respondents to the client survey answered that they would not be able to detect any difference in credibility. Among those firms that responded that they would be able to detect differences in credibility, the primary factors cited by the respondents as to why they would assign greater credibility to one firm's work than to another were the reputation of the firm or individual accountant, and the size of the firm. The price charged played no role in assessing credibility, but the time and attention devoted to the work did appear to be of some significance. However, in the case of this latter variable, one cannot assess credibility *ex ante* with the use of this variable. Thus, it would appear that

Table 30

Distribution of Business Clients Who Purchase Audits by Whether They Feel That There is a Difference in the Credibility (or value) of Audits Performed by Different Public Accountant Firms

	Clients		
	Small	Medium	Large
Feel there is a difference	50.0%	33.3	44.8
Feel there is no difference	50.0	55.6	51.7
Don't know	-	11.1	3.4
Number of Clients	6	18	29

the size or reputation of the firm strongly correlates with perceptions of quality of service.

When the clients were asked to cite the reasons for satisfaction with their accountants, the two most commonly cited responses were that the firm or accountant provided good, quick work and devoted considerable time and attention to the client's needs. Together these two represented just over 68% of the responses. As for the reasons for dissatisfaction, the primary factors mentioned were the lack of business advice and the waste of time on non-essentials. In effect, clients were not too concerned with the standards of the work, but were concerned with the usefulness of the advice provided, the personal attention and the ability to obtain results rather quickly. The importance of this latter variable -- good, quick work -- suggests that a client might be willing to trade-off quality for promptness, keeping price constant. And indeed, in the interviews with third party users, particularly representatives of the chartered banks, an up-to-date statement was considered as important, if not more important, than one that provided old information but was undertaken in a more time consuming and high quality manner. From the point of view of the lender, current information may be somewhat more useful than the quality of the service provided since the provision of an audit or non-audit review does not provide any measure of the future performance of the company. The primary purpose of such reviews is to provide an accurate assessment of past performance, and thus provide information to

a third party user of where the company stands at a given point in time. In determining the risks associated with a loan, a lending institution is more concerned with the future performance of a business firm and hence requires up-to-date information on that firm.

While the majority of the clients interviewed responded that they could differentiate among firms in terms of quality and, in turn, responded that they basically associated quality with reputation and/or size of firm, the vast majority of respondents stated that they did not know what the prices of other accounting firms were. As can be seen in Table 31, two-thirds of the respondents had no information on prices of other accounting firms. It is surprising, considering the lack of information on prices by clients, that such a low proportion of the clients negotiated the total fee for the purchase of a service from a public accounting firm. Only in the case of large clients did a sizable proportion (see Table 32) negotiate the total fee. In most cases, an open-ended arrangement seemed to be quite common. For approximately 75.6% of the small firms, a flat rate invoice was sent. Moreover, the fee was not negotiated or discussed in any considerable detail beforehand. In the case of medium-and large-size clients, the proportion of non-negotiated engagements totalled 62.5% for medium clients and 42.1% for large clients. The figures in Table 32 support the statements made by accounting firms in our interviews with them. In effect, the accounting firm has a high degree of discretion in setting fees, and quantity and quality of service to be provided

Table 31

Distribution of Business Clients by Knowledge of Prices Charged by Other Accounting Firms

	Clients		
	Small	Medium	Large
No knowledge	65.2%	58.3	73.5
Some knowledge	34.8	41.7	26.5
Number of Clients	23	24	34

Table 32

Distribution of Business Clients by Means by Which Total Price for Accounting Services are Determined

	Clients		
	Small	Medium	Large
1. Total fee is negotiated	21.8%	12.5	44.2
2. Estimate is given before the commencement of the engagement	4.3	16.7	5.9
3. Flat rate invoice is sent	69.6	62.5	44.1
4. Other	-	8.3	2.9
5. No answer	4.3	-	2.9
Number of Clients	23	24	34

to the clients. The accounting market appears to operate with a high degree of imperfect knowledge and information on the part of the clients.

Despite the lack of price information, a surprisingly small proportion of respondents to the client survey stated that they felt that they had been overcharged: 64% of the respondents (see Table 33) answered that they felt that they had not been overcharged, while only one-third responded that they did feel that they had been overcharged. With regards to the mix of people sent to perform the various services, we find that for small clients, students were rarely sent to perform accounting services, whereas in the case of the large clients, it was a common practice for students to come and perform the functions. However, over 73% of the respondents that did have students come and perform some of the accounting services believed that the students were adequately supervised (generally because they were accompanied by, or reported to a senior accountant).

The information we obtained from the user interviews suggests that third party users associate quality with size of accounting firm as well as with the designation of the accountant. For example, in the discussion with the representative of an investment banking firm, we were told that it was quite rare for the investment banking firm to have contact with other than the large national public accounting firms. In the underwriting area, in the opinion of the individual interviewed, it was quite critical to have a large

Table 33

Distribution of Business Clients by
Whether They Feel That They Have Been Overcharged

	Clients		
	Small	Medium	Large
Not overcharged	71.4%	58.3	67.6
Overcharged	28.6	41.7	32.4
Number of Clients	21	24	34

national firm involved in preparing the prospectus. Securities are priced on the basis of perception of quality of information and according to the interviewee, the public perception of quality was highly correlated with the reputation and size of the accounting firm.

In the interviews with chartered bank officials, it was generally stated that the apprenticeship and practical experience requirements necessary to obtain a CA designation made CA's uniquely qualified for performing auditing functions. The bankers also noted that they believed that the big eight national firms provided opinions that were more desirable or more credible than opinions provided by the smaller firms. Even among the big eight, there was an implicit ranking of the quality of the various firms. As a result, the bankers generally recommended that as their customers grew in size, they switch to the large firms because of the higher quality, non-public accounting services available, as well as the higher quality auditing services available. According to the bankers, the name and reputation of the public accounting firm was much more important to them than the specific accounting designations of the members of the firm. Nevertheless, some of the bankers interviewed stated that in the case of a small client, it might be desirable, in certain situations, to have non-audit reviews performed by smaller public accounting firms since the information would likely be prepared more quickly and thus be more up-to-date than if a larger firm were to perform this task. But off-setting this possible advantage was a point made by one banker that small

practitioners are generally overworked. As a result, this banker wondered whether these small practitioners, particularly young public accountants building their practice, could effectively be on top of all the affairs of all their clients and thus provide at all times the highest quality service. Indeed, given the data presented in Table 22 on the number of client-days per employee, and client-days per CA, this concern seems to be well founded. In addition, a few of the accounting firms that were interviewed stated that the larger firms had a more even workload, whereas for the smaller firms there were definite periods of peak activity and a more irregular workload. Consequently, the likelihood of overworking and errors could be a significant factor in assessing the quality levels of the services provided by smaller accounting firms.

In summarizing this section, we can state that the pricing behaviour of the accounting industry is consistent with the segmentation model described in Section I. That is, there is a rather distinct difference in fees charged for various services to clients of different size, with fees tending to increase with the size of the client. The increase in fees does not always reflect the greater time input or greater complexity in the problems encountered in providing a service to a larger client. In some cases, the higher fees simply reflect the higher profitability of the client and the greater ability to pay.

On the subject of quality, clients appear to be better informed

on this aspect than on price; however, the principal signals of quality appear to be firm size and reputation of the firm. While,on the basis of the data and information that we have obtained from accounting firms, clients and third party users, there does appear to be a positive correlation between quality of service and size of firm, as well as reputation of firm, this correlation does not necessarily insure that distinct quality differences will appear in the provision of services to small clients. What is more likely to happen is that the quality of the service may be far higher for the services provided by large firms to large clients than is the case for the services provided to small clients, whether it be by small public accounting firms or by large public accounting firms. One reason for this latter conclusion is that it is more likely that a non-audit review will be performed for small clients. The principles employed in an audit are much more rigorous and stringent than in the performance of a non-audit review. As well, there is a greater degree of latitude in terms of the tasks that can be performed to meet the minimum requirements of a non-audit review. Furthermore, an audit is much more time consuming than is a non-audit review, and hence more costly. As well, the risks, in terms of lawsuits to public accounting firms, are far greater with respect to audits than to non-audit reviews, and thus there is a greater onus on public accounting firms to do a more careful job in conducting audits than in non-audit reviews. One must bear in mind, however, that the "optimal" level of quality in the small client segment is not necessarily the highest. The important question is whether the supply of, and demand for, quality are well matched in the various segments.

FOOTNOTES TO CHAPTER 2

1. Most large firms may not be at a bargaining disadvantage vis-à-vis the lending institutions. In most cases, such firms are required by law to have annual audits performed. Where there are large private firms that are not required by law to have audits, and they contact lending institutions to obtain financing, these larger enterprises may be able to bargain with the lending institutions over the need for an audit of their financial records.

2. Industrial organization, being in effect applied microeconomics, is generally concerned with the efficiency issue; that is, whether the industry is structured in such a way or the participants behave in such a way as to replicate the competitive industry ideal - equality between the prices paid for services and/or products and the social marginal costs of providing these services and/or products. Any divergence between price and social marginal cost implies that the optimal efficiency conditions will not be met and that society will not be able to achieve the greatest aggregate level of satisfaction. Under these circumstances, increasing the level of competition or through regulation generating competitive type results can improve the overall social welfare of society. In effect, the aggregate level of production can be increased for a given level of inputs. Obviously, if output cannot be measured, neither can its price and, in turn, its social marginal cost. Therefore, the assessment of whether or not the industry is emulating the competitive ideals and operating most efficiently becomes a futile exercise and thus what becomes more important is a more non-traditional analysis focusing on the behaviour of the firms in the industry and the effects on the performance of the economy, primarily in terms of growth, inflation, etc.

3. The complete discussion of the findings of the clients survey can be found in the report of the survey by Janet Myers. This report is on file with the Professional Organizations Committee.

4. In the case of firms with one CA, the CA was obviously the proprietor of the firm.

5. We are using the term "employed" in the general sense to include not only employees of these firms but also partners of the firm.

6. Three of the five largest public accounting firms responded that they receive no fees from the provision of management advisory services since these services were provided through a separate subsidiary.

FOOTNOTES (cont'd)

7. The selected statistical parameters that we report in Table 6 are R-bar squared (the adjusted coefficient of determination), the F score, the standard error estimate (SEE), the mean of the dependent variables and the number of observations (NOBS). The R-bar squared is adjusted for the number of independent variables included in the equation. The F statistic measures in effect the significance of the equation. It is primarily a test of whether all the coefficients of the independent variables in the equations are significantly different from zero. An F score greater than 3.0 suggests that the coefficients are significantly different from zero. The t values, (the values beneath the coefficients) provide a test for each coefficient separately. Absolute values greater than 2.0 on a t score suggest that the coefficient is statistically different from 0 at a 99% significance level.

8. The observations for the non-CA, non-CGA, non-RIA firms were not included in the regression analysis. Due to the wording of our questionnaire which asked for numbers of personnel with particular accounting designations, there were few responses providing meaningful data on the number of accountants in these firms. The inclusion of the small proportion of respondents among the sample of firm observations would have introduced a further bias into the results. In light of the general similarity between one-CA or one-CGA firms, and these public accounting firms in question, we do not believe that the results would have been significantly different if we had had a complete sample of the firms.

9. The reason for this stems from the high correlation between the CA/CGA variable and the proportion of fees from large business enterprise variable, and the negative coefficient on the latter variable.

10. It should be pointed out that the coefficients reported represent rough estimates of the true relationship between the dependent and independent variables. Given the rather low R-squared values for most of the equations, we suggest that there is still much noise in the data and much of the variation across accounting firms in the proportion of fees earned from the various services is unexplained.

11. It should be noted that we do not know whether this pattern of service characterizes all public accounting offices operating outside Metropolitan Toronto. Specifically, we do not know whether it characterizes branch offices of Toronto-based firms, since we asked that head offices report all of their Ontario operations together. Whether branch offices have patterns of service more similar to the patterns of their Toronto head office than to the patterns of other public accounting offices in their locality (or vice versa) is something we cannot infer from our data.

(footnote 11 cont'd...)

FOOTNOTES (cont'd)

11. (cont'd) We can, however, report the following data regarding the branch offices of firms in our sample. Firms with their head offices in the Metropolitan Toronto area may have branches in rural and smaller urban areas of Ontario. However, as the data in the accompanying table demonstrate, firms with head offices in the Toronto region are most likely to have branches in the major urban areas and less likely in the smaller urban or rural areas. For example, 46 of the 89 branches of firms with head offices in the Toronto suburban fringe were located in urban centres with a population in excess of 100,000. For firms with their head offices in Toronto, 202 of the 271 branches were in urban centres with more than 100,000 residents. More than half (124 of 226) of the branches in smaller urban centres and rural areas (population less than 100,000), were operated by firms with their head offices outside the greater Metropolitan Toronto area.

Distribution of branches in population centres of different size, by firms of different size and with head offices in various regions.

		No. of Branches by Population of Locality					
Post Code	Type and Size of Firm	Under 5,000	5,000-30,000	30,001-100,000	100,001-500,000	Over 500,000	Total
K	CGA	2	1	-	2	-	5
	CA-1	11	4	4	9	-	28
	CA-2	2	4	2	2	-	10
	CA-3	-	1	1	2	-	4
	CA-4-5	-	-	-	1	-	1
	CA-6-10	1	1	1	2	1	6
	CA-11-25	-	2	1	1	-	4
	CA-26-150	-	-	-	-	-	-
	CA-151+	-	-	-	-	-	-
	Total	16	13	9	19	1	58
L	CGA	1	4	5	4	-	14
	CA-1	7	4	9	23	3	46
	CA-2	-	2	-	3	4	9
	CA-3	-	4	2	4	-	10
	CA-4-5	-	2	2	1	1	6
	CA-6-10	-	1	-	1	-	2
	CA-11-25	-	-	-	1	1	2
	CA-26-150	-	-	-	-	-	-
	CA-151+	-	-	-	-	-	-
	Total	8	17	18	37	9	89

(footnote 11 cont'd...)

FOOTNOTES (cont'd)

11. (cont'd)

Post Code	Type and Size of Firm	No. of Branches by Population of Locality: Under 5,000	5,000-30,000	30,001-100,000	100,001-500,000	Over 500,000	Total
M	CGA	2	-	-	-	10	12
	CA-1	3	-	1	1	91	96
	CA-2	-	-	1	-	24	25
	CA-3	-	1	-	-	16	17
	CA-4-5	-	-	-	-	14	14
	CA-6-10	-	-	1	1	7	9
	CA-11-25	-	3	1	1	7	12
	CA-26-150	18	13	14	6	6	57
	CA-151+	-	-	2	24	4	30
	Total	23	17	20	33	179	272
N	CGA	1	2	2	5	-	10
	CA-1	8	8	5	11	-	32
	CA-2	3	4	1	3	-	11
	CA-3	-	2	2	3	-	7
	CA-4-5	1	3	4	5	-	13
	CA-6-10	3	6	1	4	-	14
	CA-11-25	-	1	-	1	-	2
	CA-26-150	-	-	-	-	-	-
	CA-151+	-	-	-	-	-	-
	Total	16	26	15	32	0	89
P	CGA	2	3	-	2	-	7
	CA-1	4	2	2	6	1	15
	CA-2	1	3	2	2	-	8
	CA-3	-	-	1	2	-	3
	CA-4-5	1	2	1	-	-	4
	CA-6-10	-	3	1	1	-	5
	CA-11-25	-	-	-	-	-	-
	CA-26-150	-	-	-	-	-	-
	CA-151+	-	-	-	-	-	-
	Total	8	13	7	13	1	42
Total	CGA	8	10	7	13	10	48
	CA-1	33	18	21	50	95	217
	CA-2	6	13	6	10	28	63
	CA-3	-	8	6	11	16	41
	CA-4-5	2	7	7	7	15	38
	CA-6-10	4	11	4	9	8	36
	CA-11-25	-	6	2	4	8	20
	CA-26-150	18	13	14	6	6	57
	CA-151+	-	-	2	24	4	30
	Total	71	86	69	134	190	550

FOOTNOTES (cont'd)

12. See footnote 11 above.

13. We used only the number of CA's and an hourly billing rate for a CA group because, while the proportion of respondents providing billing rate data was generally low, the proportion was extremely low for the CGA firms. Using a CGA billing rate as well would have resulted in the inclusion of too few additional observations to be worth the effort.

14. See P.E. Hart, "On Measuring Business Concentration", Bulletin of the Oxford Institute of Statistics (August,1957), for a discussion of the limitations of traditional measures of concentration.

15. Since 1962, only newly-designated CA's have been able to join the ranks of public accountants. Consequently, in the absence of any revisions to The Public Accountancy Act, there will continue to be a decline in the number of non-CA public accounting firms in Ontario. With the exception of the personal clients of the non-CA public accounting firms, it is not possible to determine where their other clients will go; that is, in terms of the size of the CA public accounting firms. Hence, in order to more accurately assess what the level of concentration will be in the absence of any regulatory revisions, it was felt that it would be preferable to calculate the concentration ratios excluding the non-CA public accounting firms. While the exclusion of these other firms will tend to bias upwards the various concentration ratios, as we have pointed out before, the exclusion of the non-respondents in the calculations, as well as other competitors in the non-public accounting areas, have also contributed a bias in these calculations, a bias which, in our opinion, is likely to be more important in its quantitative impact.

16. For example, in calculating the five- and nine-firm concentration ratios for auditing fees, we used the proportion of total fees accounted for by auditing for the eight different firm size categories -- the figures or proportion of fees earned from auditing were those reported in Table 3 - and multiplied these figures by the number of CA's in each of the eight firm size categories -- the figures were reported in Table 1. We then cumulated the resulting values and took the proportion for the five largest firms and the proportion for the nine largest firms.

FOOTNOTES (cont'd)

17. The starting assumption was that the average fee for the fee categories were as follows: $500 in the $0-$1,000 category; $5,000 in the $1,000-$10,000 category; $30,000 in the $10,000-$50,000 category; and $80,000 in the $50,000 and over fee category. The second assumption was that the average fee per client-day was $250 for all firm sizes. Obviously, it is likely that the average fee per client-day is greater in the larger firms relative to the smaller firms. Nevertheless, we saw no objective manner in which we could adjust for this particular relationship. However, we did believe that it would be necessary to adjust for the average fee for various fee categories across firms in light of the above argument. Consequently, we adopted the following procedure: For each firm size category and each fee size category we calculated the proportion of total clients in that category for the firms in each firm size category. Then, we repeated this exercise using instead the proportion of the estimated "gross fees" in each fee category accounted for by the firms in each firm size category. The estimated gross fee figures were the same as those used in the calculation of the concentration ratios for the four fee categories. We then divided the latter set of proportion by the former set of proportions and the resulting set of factors were the adjustment values. These adjustment values were then multiplied by the average fee in each of the fee categories to give us an average fee for the various fee categories for each of the firm size categories. A rationale in using this adjustment was that for those firms in which the proportion of all fees that they obtained exceeded the proportion of clients that they had in a given fee category, the average fees were in excess of the average fees charged by firms for which the reverse situation held. The adjusted average fee rates were then multiplied by the number of clients in the respective fee categories to derive an estimate for gross client fees. The estimates for gross client fees were then divided by 250 to provide an estimate of the number of client-days.

18. Obtaining information from these various sources is analogous to unemployed workers obtaining information from want ads, Canada Manpower Centres, friends, relatives, etc. before they go out and actually contact employers for job vacancies.

19. One could argue that it would be better for the lending institution to incur the cost of obtaining the information, because in most cases they are better able to incur the costs and risks and spread them out over a large number of clients. Using standard insurance principles, the risks of a non-acceptance of a loan demand should be spread out over a large number of clients rather than be placed on one client. This will result in a more efficient spreading out of the risks and generally lower costs for obtaining information. The lower

(footnote 19 cont'd...)

FOOTNOTES (cont'd)

19. (cont'd) costs will stem from a greater familiarity of the work performed by certain group of accountants/auditors if they are hired by the lending institution, as against attempting to distinguish among firms, in the quality of their work, if they are hired by the client demanding a loan.

20. We should point out that most large corporations are being ignored in this discussion because they generally require audits for statutory reasons.

21. For a complete discussion of the factual and impressionistic information obtained from the client survey see the study by Janet Myers noted above. The tables and summaries discussed in this section of the report are based entirely on the information reported in the study by Ms. Myers. Briefly, the survey was conducted as follows: A stratified random sub-sample of fifty-six "small" firms ($25,000-$249,999 gross revenue), forty-six "medium-sized" firms ($250,000-$999,999), and fifty-six "large" firms (over $1,000,000) was drawn from a Dunn and Bradstreet random sample of firms in Ontario. Questionnaires were mailed to each of these firms. Our researcher then discussed the questionnaire in personal or telephone interviews with representatives of those firms who agreed to participate. Of the 120 firms originally contacted, eighty-five returned questionnaires.

22. We are implicitly assuming that this average hourly billing rate serves as an appropriate proxy for the average billing rates for the firms and as well as an appropriate proxy for the overall fees of particular accounting engagements. We use this particular average hourly billing rate because we got the largest number of responses for this variable from the firm surveys.

23. CGA firms were excluded from this analysis, as in the regressions in which average hourly billing rate entered as an independent variable, since we had average hourly billing data for only eight CGA firms.

24. The firms interviewed were unanimous in stating that the large public accounting firms are in an advantageous position in creaming off the top university graduates enrolling in the CA program, because of their ability to recruit on-campus, their greater public visability and their ability to pay the highest salaries. Medium-size firms attracted the second layer of university graduates applying to the CA program, while small firms simply accepted whoever remained and applied

(footnote 24 cont'd...)

FOOTNOTES (cont'd)

24. (cont'd) to them. In the cases of small firms operating outside the greater Metropolitan Toronto area, they were forced to accept students in non-CA accounting programs, such as CGA's and RIA's. If one associates performance in a university program with potential quality or skill as an accountant, it would appear that the large public accounting firms employ the highest quality or the potentially highest quality students, whereas the smallest firms employ students with a correspondingly lower potential in terms of quality. These factors together with the ability of larger firms to keep a larger proportion of their students who receive the CA designation suggest that even though the mix of individuals providing routine public accounting services might be skewed towards more junior, less experienced individuals in a large firm vis-à-vis the smaller firms, the potential quality differences might off-set the experience differences.

25. The data in the accompanying table show that the average rate of pay for four categories of students as well as starting salaries for newly designated CA's, CGA's, and RIA's do not differ markedly across CA firms of different size. The bottom end of the salary range for the various groups tend to be, however, lower in the smaller firms. Moreover, as expected, the average salaries are higher for CA students or newly designated CA's than for non-CA students and newly designated CGA's and RIA's. While average salaries do not differ significantly across firms, the larger firms are more likely to employ only CA students, while the smaller CA firms will just as likely hire CA and CGA students, most likely to lower their costs.

(footnote 25 cont'd...)

25. (cont'd)

Selected Statistics on Students and Newly Designated Accountants, by CA Firms of Different Size.

		Number of CA's in Firm							
		1	2	3	4-5	6-10	11-25	26-150	151+
Annual Salary ($000's)									
Full-time CA students	-avg.	10.7	12.2	9.6	10.0	9.4	10.0	10.2	10.8
	-range	7.5-24	8-24	7-14	7.3-19	6.5-12	8.5-13	9.4-11	10.5-11
Co-op CA students	-avg.	8.6	6.6	7.0	6.8	7.0	7.2	7.5	6.9
	-range	8.2-9	5.2-7	6.3-7.5	5.5-8.5	6.0-9.6	6-10	6.5-9	6-7.6
CGA students	-avg.	9.6	7.4	9.3	7.8	7.6	8.4	7.0	8.8
	-range	6-18	5.2-10	6-14	5.2-12	6-10	6.6-10	6-7.9	8.4-9.3
RIA students	-avg.	10.4	9.3	8.0	10.0	7.5	7.0	7.9	8.4
	-range	6-16	8-10	6.3-10	5.5-16	6-8.5	6.6-7.5	-	-
Newly Designated									
CA's	-avg.	15.8	17.0	16.3	16.4	15.7	15.6	15.5	16.5
	-range	10-24	10-26	10-20	9-24	7.5-24	10-18	13-18	16-17
CGA's	-avg.	12.7	13.3	14.1	13.4	12.9	10.8	11.7	-
	-range	8-16	10-17	12-18	8-16.5	9-18	7.5-15	11-12	-
RIA's	-avg.	12.5	12.5	13.2	13.0	13.2	11.2	11.5	16.0
	-range	9-18	10-18	11-15	12-16	9-18	7.5-15	11-12	-
Number of Students									
CA's	-total	23	23	48	152	144	167	271	490
	-av. per firm	0.1	0.3	1.0	2.6	5.3	11.9	67.8	98.0
CGA's	-total	23	36	29	40	14	15	40	12
	-avg. per firm	0.1	0.4	0.6	0.7	0.5	1.1	10.0	2.4
RIA's	-total	21	4	3	4	8	3	9	1
	-avg. per firm	0.1	0.0	0.1	0.1	0.3	0.2	2.2	0.2

CHAPTER 3.1

THE REGULATION OF PUBLIC ACCOUNTING IN SELECTED JURISDICTIONS OUTSIDE ONTARIO

INTRODUCTION

In undertaking this study, the authors were asked to address three main issues:

1. Which of the range of functions currently performed by accountants require regulation? What is the appropriate division of these functions among occupational groups?
2. Is there a case for specialty designations in accounting? If so, which designations are appropriate?
3. What institutional arrangements are appropriate for regulating these functions and designations?

One of the modes of analysis chosen was comparative. Since the regulation of the accounting field is a provincial or state matter, there was a strong feeling that an examination of practices in other jurisdictions would help to determine the "appropriate" level of regulatory activity for Ontario.

The first decision, then, was to decide which other jurisdictions to select for comparison. This, in fact, was the key decision since a choice of jurisdictions whose political traditions and institutions are very different from those found in Ontario would have had questionable value. Likewise, jurisdictions whose economic structures varied substantially from Ontario's would have had relatively less value as examples of regulatory alternatives.

The jurisdictions chosen for detailed review minimize these dangers while exhibiting a range of alternative regulatory patterns. Four are Canadian provinces; two American states. Quebec was chosen for inclusion because its economy is of similar size and composition to that of Ontario while from a regulatory perspective there are marked differences. Since 1973, the province's professions have been closely regulated through the enactment of the omnibus professional code which established an office of professions to oversee those aspects of professional activity that directly affect the well-being of the public.

Saskatchewan, though economically dissimilar to Ontario, was included because it provided an opportunity to review a jurisdiction in transition from an unregulated environment for public accounting to what may become regulatory legislation modelled on that of Ontario. The analysis of the draft legislation proposed for Saskatchewan shows the interests at work in the framing of such legislation.

Alberta was included because it provides an example of a completely unregulated province, vis-à-vis public accounting. British Columbia, on the other hand, can be described as a "mixed" or restricted regulatory scheme. While The Companies Act in B.C. restricts the audit function to specifically trained and designated accountants, the definition of companies requiring an audit is more restricted than that found in Ontario. Moreover, B.C. is the only province where a sizable number of non-CA's are practising public accounting.

The two U.S. states - California and New York - are analyzed in spite of their obvious differences in law, institutions and traditions. There are two reasons for including these two states. First, they have well developed economies in which the full range of accounting requirements can be found. Second - and the second reason is unique to each - California is included because it is frequently cited as a bellweather for legislative innovation and reform; New York because the definition of public accounting in force in Ontario was modelled after the one in that state.

To address the issues posed, the analyses concentrate on a number of points in each jurisdiction; principally:

a) What regulations are currently in force and how do those regulations define the restricted area of practice?

b) What route or routes are available to those individuals wishing to practise in the defined area?

c) What developments have occurred that might change the division of functions among professional groups or change the form of the professional groups themselves as in the case of mergers?

d) How has the absence of regulatory legislation changed the way in which public accounting is performed in a jurisdiction?

Not all of these questions have been addressed in all of the jurisdictions reviewed. Indeed, to address them at the detailed level at which they are being analyzed in Ontario was clearly

impossible. For this reason, each chapter presents a more or less factual account based on a review of relevant materials and discussions with individuals in Saskatchewan, Alberta and British Columbia.

Reviewing briefly the regulatory situation as it currently exists across Canada, we find that of the ten provinces, six regulate the practice of public accounting in some form (see Table 3.1.1.). In four provinces - New Brunswick, Manitoba, Saskatchewan and Alberta there are no restrictions of any kind. In British Columbia there are restrictions limited to the auditing of "reporting" or public companies. Quebec restricts all public accounting except audits of municipalities, school boards and co-operatives. The remaining four provinces, Newfoundland, Prince Edward Island, Nova Scotia and Ontario have restrictions that require licensing. In all four, membership in the provincial Institute of Chartered Accountants is the normal avenue to the licence.

Before beginning the detailed review, it may be useful to recapitulate briefly the role and status of the three main professional associations of accountants.[1] The provincial Institutes of Chartered Accountants together form the largest and oldest professional group in the field. Although the Institutes' membership is split almost evenly between industry and public practice, the latter are the pre-eminent group in the field of public accounting in this country. All of the national firms, serving the major industrial clients as well as the majority of smaller

TABLE 3.1.1.

PUBLIC ACCOUNTING REGULATORY LEGISLATION IN CANADA

Province	Act/Year	Board/Composition	Eligible to Practise	Qualification for Licensing
Newfoundland	"An Act to Regulate the Practice of Public Accountancy" 1967	Public Accountant's Licensing Board comprised of seven members (5 nominated by the Institute from their membership, one public accountant, not a member of the Institute and a chairman who is to be a lawyer.	Licensed under Public Accountant's Licensing Board	Normally applicants should be members of the Institute of Chartered Accountants of Newfoundland.
Prince Edward Island	"Public Accounting and Auditing Act" 1951		Licensed under Public Accounting and Auditing Act	Members of the Institute of Chartered Accountants of PEI or the holder of a license to practice which is controlled by the Institute.
New Brunswick	No regulatory legislation		No restriction	
Nova Scotia	"Public Accountants Act of the Province of Nova Scotia" 1967	The Board is comprised of 5 members as follows: 3 members appointed by the Governor in Council, 2 members appointed by the Institute of Chartered Accountants of Nova Scotia	Persons licensed under the Board	Normally applicants should be members of the Institute of Chartered Accountants of Nova Scotia.
Quebec	"Chartered Accountants Act" 1946 "Professional Code" 1973		Members of the Order of Quebec with the exception that other accounting bodies may perform audits of municipalities, school boards and co-operatives.	

Province	Act/Year	Board/Composition	Eligible to Practise	Qualification for Licensing
Ontario	"Public Accountancy Act" - 1950 (revised 1962)	Council composed of 15 members - 12 appointed by the Institute of Ontario and 3 of whom are elected by persons who are licensed under the Act but are not members of the qualifying body	Members licensed under Council	Members of the Ontario Institute
Manitoba	No regulatory legislation		No restriction	
Saskatchewan	No regulatory legislation		No restriction	
Alberta	No regulatory legislation		No restriction	
British Columbia	Companies Act 1973.	Board comprised of a CA, a CGA an RIA and not more than two other persons.	Only CAs, CGAs or persons approved by the Auditor Certification Board set up under the Companies Act are eligible to audit public companies. There is no restriction on the audit of other organizations.	
Yukon	No regulatory legislation		No restriction	
NWT	No regulatory legislation		No restriction	

Source: The Canadian Institute of Chartered Accountants.

(including one-and two-man) firms are composed of chartered accountants. The Institute leads in the field of research and enjoys a high reputation for its efforts in the area of ethics and professional conduct. (See Table 3.1.2. for current membership figures by province.)

The Society of Management Accountants, until recently the Society of Industrial Accountants, focuses on the field of management or "internal" accounting as opposed to the public accounting area. Management accountants normally are employees and firms of management accountants are uncommon. The Society provides research and education programs to its members and students. In Ontario, The Public Accountancy Act includes a section specifically exempting the functions of management accountants from the licensing provisions. Similar sections are to be found in the acts of other jurisdictions. Notwithstanding such exemptions, the Society has in the past tended to become actively involved in regulatory issues, submitting briefs and joining in discussions respecting mergers or amalgamations of the three professional groups. (See Table 3.1.3. for membership information.)

The Certified General Accountants Associations in each province and nationally form the third major group. To some extent, the CGA's are a hybrid of the two previous groups since their members are involved in both management and public accounting, the latter in those provinces where it is permitted by law. Where the regulatory scheme provides or where no regulations are in effect,

TABLE 3.1.2.

Membership in the Canadian Institute of Chartered Accountants as of March 31, 1977

	Members (CA's)	Students
British Columbia	2557	710
Alberta	2140	842
Saskatchewan	714	195
Manitoba	1369	313
Ontario[a]	10,906	3784
Quebec	6690	1632
New Brunswick[b]	353	168
Nova Scotia	540	229
P.E.I.	52	35
Newfoundland	227	143

a. as of February 28, 1977

b. as of April 30, 1977

Source: The Canadian Institute of Chartered Accountants

Note: Students are not considered members of the Institute

TABLE 3.1.3.

Membership in the Society of Management Accountants as of December 31, 1977

	Registered Members (RIA's)		Students	
British Columbia	(761)	811	(1615)	1695
Alberta	(1074)	1186	(2019)	2167
Saskatchewan	(231)	257	(844)	928
Manitoba	(586)	618	(1243)	1228
Ontario	(4171)	4542	(9898)	10481
Quebec	(1451)	1530	(1643)	1875
New Brunswick	(151)	162	(267)	270
Nova Scotia	(278)	301	(634)	635
P.E.I.	(14)	14	(23)	21
Newfoundland	(55)	63	(152)	150

Source: The Society of Management Accountants

Note: Figures in brackets are for December 31, 1976.

the CGA Associations encourage their members and students in both areas through a series of options offered in the final year of their academic program. The CGA Associations have been very active on regulatory issues and have sought access to the public accounting field where it is or might become restricted. (See Table 3.1.4. for membership information.)

In spite of their many differences, the three groups have at least several similarities. All three:

a) have members in every province;

b) operate a national educational course and hold a national examination(s);

c) require that practical experience be obtained prior to certification;

d) have a national code of ethics.

As mentioned, both the CA's and RIA's undertake research programs in their field of interest. The CGA's work through the CICA and its research program.

This concludes the introduction. In the chapters that follow, the reader will find substantial detail on the practices in other jurisdictions. However, much of the background on education, training requirements, admission requirements has been omitted except as it differs from that found in Ontario.

TABLE 3.1.4.

Membership in the General Accountants Association of Canada as of December 31, 1977

	Certified Members (CGA's)	Undergraduates
British Columbia	1459	2767
Alberta	261	1178
Saskatchewan	19	51
Manitoba	87	723
Ontario	2589	6881
Quebec	2184	3857
New Brunswick	91	253
Nova Scotia	75	164
P.E.I.	20	40
Newfoundland	65	208
Northwest Territories	12	25
Non-residents in Prairie Region	11	3
Non-residents in Atlantic Region	21	133
TOTAL:	6831	16283

Source: The Certified General Accountants Association of Ontario

CHAPTER 3.2

PUBLIC ACCOUNTING IN QUEBEC

A. INTRODUCTION

The passage of Bill 250, the Quebec Professional Code, in 1973, was a milestone in the regulation of the professions in that province. The main objects of the Professional Code are the establishment of procedure and rules of discipline to be followed by the professional corporations subject to the Code, the institution of a uniform system for determining the quality of professional services performed, the establishment of an Office of the Professions to ensure that the professional corporations meet the requirements for protection of the public and finally the establishment of an Interprofessional Council to develop and make recommendations to the government.

While a detailed analysis of the many provisions of the Code clearly goes beyond the scope of this paper, those sections dealing with the jurisdictional decisions in the field of public accounting are of direct interest and will be covered in detail.

Public accounting has been regulated in Quebec since 1946 when "An Act to Regulate the Practice of Accountancy and Auditing" received Royal assent. The first legislation of its kind in Canada, the Act defined a "Public Accountant" as "a person who engages for remuneration in the art or science of accountancy, but does not include a person who acts exclusively as a bookkeeper

whether or not he offers his services to the public." The Act provided exemptions from the regulations for the accountants and auditors of the following:

(i) municipalities[2] (not including the City of Montreal);

(ii) school commissions;[3]

(iii) co-operatives;[4]

(iv) savings banks and credit unions.[5]

With the exemptions noted, the public accounting field was effectively closed in 1946. The right to practise public accounting was granted to Chartered Accountants but not exclusively, since "acquired rights" to practise in the field were preserved through a series of "grandfather" clauses similar to those provided in the Ontario legislation. Certified Public Accountants (CPA's) joined the Institute of Chartered Accountants. Certified General Accountants engaged in public accounting or employed by the federal or provincial (Quebec) governments and resident in Quebec at the time were also admitted to the Institute without further examination. Other members of the CGA Association in 1946 who subsequently wished to practise public accounting could do so by obtaining a licence from the Institute and could be admitted to membership. To secure a licence, the individual had simply to present a written request and provide proof of Quebec residency and employment in public accounting (as the principal means of livelihood) for at least one year.

A third group was also considered. Those accountants who were not members of the CGA or CPA Associations could apply to the

Institute for a licence to practise. They were required to demonstrate that they had been practising public accounting as the principal means of livelihood within 120 days following the passage of the Act. This group were designated "Registered Public Accountants" and although not members of the Institute were required to abide by the Institute's Rules of Professional Conduct.

Finally, an exception was given to 202 Accredited Public Accountants in the public accounting field at the time of passage. This group was permitted to continue practising and to designate themselves as APA's. Individuals admitted to membership in the Institute of Accredited Public Accountants after the Act came into force could neither practise public accounting nor use the designation.

Membership in the Institute of Chartered Accountants was open to public accountants with five years experience who could demonstrate to a three-man Board of Academics their experience qualifications as well as attest to their character and habits. This membership option was infrequently exercised.

The feature of this regulatory legislation that was to cause "problems" was not the inclusion under the licensing provisions of numerous "grandfather clauses" since in virtually all cases these restricted areas to those practising public accounting in 1946. The "problem" area was created by the exemption of audits

of municipalities, school boards, co-operatives and credit unions. While the exemptions were ostensibly granted to compensate for the undersupply of licensed public accountants in many of the province's smaller centres, the net effect has been to provide a basis for public practice by unlicensed accountants. A Chartered Accountant writing on the situation in Quebec comments that:

> Accountants who opened offices ostensibly to offer services in these specific areas have, however, been accepting engagements in the restricted field of public accountancy. It has cost our Institute a great deal of money in legal fees to oppose this practice.[6]

This then was the situation in Quebec up to the early 1970's when the government enacted Bill 250, the Professional Code.

B. THE QUEBEC PROFESSIONAL CODE

Growing out of some of the recommendations of the Castonguay-Nepveu Report on the professions; the Quebec Professional Code provided umbrella legislation for all professions in the province. The explanatory notes preceding the Act set out the objects of the Act as follows:

> The main object of this Bill is to establish procedure and rules of discipline to be followed by the professional corporations subject to the Professional Code, to institute a uniform system as regards these

> corporations for ascertaining the quality of the professional acts done by their members, to constitute a Quebec Professions Board (Office des Professions) to see that the professional corporations ensure the protection of the public, and to set up a Quebec Interprofessional Council which will make recommendations to the Board and to the Government. [7]

The Code creates two kinds of professional corporations: those which have exclusive rights to practise within a defined field and those that have a reserved use of a title but not exclusive right to practise. In the accounting field, Chartered Accountants were created as a corporation of the first kind while CGA's and RIA's were given the status of corporations with a reserved title.

Section 26 of the Code sets out the conditions for exclusivity of rights to practise:

> The members of a corporation shall not be granted the exclusive right to practise a profession except by an act; that right must not be granted except in cases where the acts done by these persons are of such a nature and the freedom to act they have by reason of the nature of their ordinary working conditions are such that for the protection of the public they cannot be done by persons not having the training and qualifications required to be members of the corporation. [8]

In accordance with the requirements of Section 26, a new Act was passed, re-establishing the Chartered Accountants in the province as a professional corporation authorized to issue permits to its members for the exclusive practise of public accountancy. A discussion of the provisions of the Act is given in Section C. The CGA's and RIA's were also reconstituted as professional corporations and given the use of restricted titles and the right to issue permits to their members. Section 37 of the Code states:

> 37. Every person entered on the roll of one of the following professional corporations may engage in the following professional activities in addition to those otherwise allowed him by law:
>
> (a) the Professional Corporation of Industrial Accountants of Quebec: establish cost accounting, do industrial accounting and organize and manage businesses;
>
> (b) the Professional Corporation of Certified General Accountants of Quebec: perform bookkeeping and industrial or commercial accounting services.

The alignment of the professional bodies in this way was by no means unanimous. In the debates preceding enactment of the Code there were clashes over the proposed arrangement and the professional bodies were active in seeking major modifications in the public accounting field. The government itself recognized the unsatisfactory state of affairs. According to Levine:

> When the National Assembly adopted Bill 264 (the new Chartered Accountants Act) in July 1973, the Minister of Industry and Commerce who sponsored the Bill declared that he was recommending its adoption only under the formal understanding that the three professional corporations of accountants recognized in the Professional Code (CA's, CGA's, RIA's) had initiated negotiations with a view to their unification. The minister's declaration was based on the findings of a Special Committee of the National Assembly on Professional Corporations set up to examine the Professional Code and the Chartered Accountants Act and other professional acts. This committee stated that the division of the accounting profession into three corporations and various minor groups did not rest on solid legal ground and was confusing to the public. It was difficult, the committee felt, for the public to distinguish between the specific duties of public accountants and those of management accountants and, in the latter group, between the CGA's and the RIA's.[9]

An *ad hoc* tripartite committee representing the CA's, CGA's and RIA's had been established in the summer of 1972, (before the passage of the Code) to consider and formulate a common merger proposal. The work and results of this committee are considered in Section D.

The Professional Code made many sweeping changes in the operations of the professions beyond the definition of restricted areas of practice. It, in effect, created an entirely new administrative structure for the professions; a structure in which the government of the province plays a far greater role in the affairs of the professions. Among other changes, the Code, in brief summary:

1. made protection of the public the paramount goal of the professional corporations;
2. established a requirement and procedure for professional inspection and retraining of those individuals found deficient;
3. involved the public directly in the affairs of the professional corporations;
4. set up a procedure for conciliation of fee disputes with arbitration;
5. amended disciplinary procedures and introduced an attorney paid by the Office of Professions to act as chairman of the disciplinary committee;
6. required uniformity of by-laws among professional corporations;

The scope and impact of the changes constitutes an in-depth study in itself and unfortunately cannot be pursued here except in the narrow area of division of functions among professional corporations.

C. THE NEW CHARTERED ACCOUNTANTS ACT

As already mentioned, the enactment of the Professional Code required the passage of a new governing Act for the Chartered Accountants. The Act was passed at the same time as the code and sets out the structure, powers and duties of the Order of Chartered Accountants under the umbrella code.[10]

The Bureau (Governing body) of the Order consists of a president and twenty elected members who act as directors. Four non-members are appointed by the Office of Professions. All must be Canadian citizens.

The Act defines the practice of public accountancy and exemptions in Section 19 as:

> Engagement by a person, for remuneration, in the art or science of accountancy or in the auditing of books or accounts and the offer of his services to the public for such purposes constitutes the practice of public accountancy.
>
> However, a person does not practise public accountancy within the meaning of this Act if he acts exclusively as a bookkeeper, provided that if he offers his services to the public, he advertises only as a bookkeeper.

The Act also maintains the exemptions granted in the predecessor

Act, provisions the Chartered Accountants had actively sought to have removed. While Section 24 grants rights to Chartered Accountants:

> Subject to the rights and privileges expressly granted by law to other professionals, no person may practise public accountancy unless he is a chartered accountant...

Section 27 maintains the rights of those practising under "grandfather" clauses, Section 28 preserves the rights of RIA's in the cost and industrial accounting fields and Section 29 states that:

> Notwithstanding the provisions of this Act, Sections 78 and 79 of The Municipal Commissions Act (R.S.Q. 1964, c. 170), and Sections 19, 22 and 27 of The Cooperative Agricultural Associations Act (R.S.Q. 1964, c. 124), Sections 86 to 92 and Section 116 of The Cooperative Associations Act (R.S.Q. 1964, c. 292) and Sections 43, 81, 87, 92 and 108 of The Savings and Credit Unions Act (R.S.Q. 1964, c. 293) continue to apply.

The Acts and Sections referred to above are those that leave these areas of public accounting open to everyone. The CA Act maintains the "bridging provisions" of the earlier act and sets out the requirements for admission of students and professionals (CA's) from other jurisdictions. In virtually all cases these requirements are similar in substance to those found in Ontario.

D. MERGER DISCUSSIONS IN QUEBEC

As mentioned above, a condition imposed by the Quebec government was that the three accounting associations begin merger negotiations. Consequently, a tripartite ad hoc committee was established with equal representation from each association. The committee was formed in the summer of 1972 and met to define goals, establish definitions of the areas of activity of members, discuss admission requirements, diplomas, study programs, examinations and training periods. Questions of organization, national affiliation and problems associated with inter-area transfers within a merged organization also received consideration.

Two years after the start of its work, negotiations broke down as the RIA's withdrew from the discussions, declaring themselves in favour of separate organizations for public and management accountants. Their arguments in favour of separate groups consisted of the following:

1. The "public" served by RIA's (management accountants) is well informed about the services that these individuals can perform.
2. In the area of ethics, grouping of management and public accountants would cause confusion.
3. The RIA's were concerned that their members would become second class citizens in a mergered group. Moreover, they felt that a professional organization should represent a homogeneity of interest.

4. The university degree entrance requirement of the CA's was higher than what RIA's felt to be necessary.
5. Separate training requirements would have to continue to exist.
6. A merged organization would require equal representation from both fields but the RIA's were concerned that public accountants would dominate because their obligations toward the public were more immediate and their interests more crucial.
7. The study programs had quite different objectives.

With these arguments, the RIA's declared themselves in favour of separate organizations for public and management accountants and presented a report to that effect to the Office of Professions in early 1975. The Order of CA's prepared a report for the government, submitted in April 1975, that concurred with the RIA's and was in favour of separate organizations. It called for the closing of the public accounting field, the absorption of all public accountants into membership in the Order and the elimination of the exemptions in the CA Act.

The CGA's, who had been in favour of a merger of the three corporations, found themselves at odds with the two other groups, especially after the RIA's concurred with the CA position in a supplement to their earlier report that proposed conferring a title on all management accountants. The offer of an RIA

designation to all those in the de facto practice of management accounting was to be open for a six-month period.

The RIA's saw the propositions put forward by them and the CA's as being of great benefit:

> For the clients of professional accountants, there would be no confusion as to their powers, obligations and duties.
>
> Each category of professional accountants would be well defined and the names of each organization properly differentiated. Public interest would be better protected and served. [11]

The Certified General Accountants expressed their surprise at the RIA's change from the position they expressed to the Parliamentary Commission, where they argued that without a complete merger of all professional accountants the public's confusion would only continue. The CGA's reiterated their stand that merger was the only solution and that in the absence thereof they would continue to pursue their own objectives. They stated that:

> It would appear to us that this solution (complete merger) eliminates confusion instead of creating it as alleged by the RIA's. Clients and employers would not have to try to distinguish between a public CA and a management CA, a public CGA and a management CGA, a public RIA, and a management RIA. It seems less

> confusing to us to have only two differentiations to make, instead of six, when appraising a professional accountant.

The CGA's, in a statement dated January 1976, reiterated their position that merger was the only desirable alternative and that mechanisms and safeguards could be found that would protect the special interests of both public and management accountants.[12] The CGA's argued that the fact of being paid by contract, by the service rendered or by the hour does not constitute a different profession from that where payment is by an employer. In their opinion, it is entirely conceivable that there be two main fields of activity without implying the existence of two professions.

The withdrawal of the RIA's from the tripartite committee prompted the Office of Professions to join in the discussions directly. Another year of negotiation followed. On May 4, 1976, the Bureau of the Order adopted a revised proposal that restates the position of the Order outlined in the April 1975 report with an added provision aimed at providing readier access to membership in the Order. The resolution was tabled before the working committee at the end of May. Levine, who was president of the Order at that time describes the proposal as "final". It proposed that:

> The Order would grant the CA designation to any person who, at a date to be specified, is practising public accountancy *de facto* or *de jure* in however small a

> field, including auditors of municipalities, school boards and co-operatives, as well as CGA's and RIA's employed by firms of chartered accountants. It is contemplated that a special board would examine each application under this provision and that there would be a time limit for applications.[13]

A bridging provision is contemplated through the recognition of a class of mature students who would be eligible for CA membership even though they did not have university degrees. This class of mature students would be similar to those eligible in the provinces of Ontario and British Columbia. Mature students who were not eligible would have to follow the usual course procedure and pass the Uniform Final Examination. Mature students who were CGA's or RIA's could, however, become members of the Order if:

(a) they had been members of their respective organizations for five years;

(b) completed two years of training in the office of a practising CA approved for training;

(c) passed a special examination in auditing, taxation, the CICA Handbook, and professional ethics.

As a part of this proposal, the public accounting field would be closed by eliminating the exemptions currently in The Quebec Chartered Accountants Act and referred to above. Levine concludes the description of the modified proposal by stating that:

> It would be most difficult in the political context of our negotiations to fail to recognize the

> professional status of the CGA's and RIA's, at least as far as their training and examinations in accounting are concerned. In any event, the RIA's fully support our proposal. The CGA's, however, have so far rejected it and have advanced certain further modifications, which are presently under consideration by our Administrative Committee and Bureau. To those who may be skeptical about the reasons for our compromise, I can only say that if it achieves effective closing of the profession and silences the demands for merger, it will be well worth it.[14]

The demands for merger were not silenced, however, and in spite of the Quebec government's direct and expressed interest in achieving a unification of the profession, the talks among the groups have broken down and show no signs of being re-established.

This is, of course, not the only example in Canada of lengthy and basically futile merger or amalgamation talks. Similar talks have been held in Ontario on several occasions, most recently between the CGA's and RIA's. Later in this study there is a review of similar efforts that took place in British Columbia. The net result has always been the same.

CHAPTER 3.3

PUBLIC ACCOUNTING IN SASKATCHEWAN

A. INTRODUCTION

At the present time there is no regulatory legislation governing the practice of public accounting in the province of Saskatchewan. Four professional associations are represented in the province. The Institute of Chartered Accountants and the Society of Management Accountants are incorporated under Acts that restrict the use of their respective titles or designations and that confer on these two groups the right to discipline members and set standards of training, education, experience and professional conduct, while not restricting any individual from offering services to the public. The Certified General Accountants Association and the Institute of Accredited Public Accountants have sought incorporating legislation to enable them to control the discipline of their members.

Recent developments in the province have centered on a proposed Public Accountancy Act that would regulate the public accounting field in the province. The task of investigating alternative models and providing the underlying rationale for such legislation was given to Mr. D.P. Lowrey, a CA and RIA who teaches at the University of Regina. Mr. Lowrey began work in the fall of 1973 reviewing legislation in other provinces, commission reports, as well as undertaking extensive discussions with various interested parties across the country. His initial report,

submitted in September 1975 consisted of a position paper outlining general objectives for the legislation and a proposed draft act intended to stimulate further discussion with interested accounting groups.[15]

Discussion of the draft proposal followed. The various accounting associations met both with each other on a panel to discuss the legislative proposal and with Professor Lowrey to provide him with input for making revisions. A revised draft proposal was released in August 1976. The revision included several major changes the details of which will be considered in the sections that follow. Overall, the revisions had the effect of changing the nature of the intended legislation from its original intention of not restricting access to public accounting licences to an effective restriction on future licences to members of the Institute of Chartered Accountants.

The Certified General Accountants Association responded negatively to the proposed revision in a letter to the Minister of Finance dated February 7, 1977. The Saskatchewan Government, in its deliberations on the proposed act, decided not to proceed with regulatory legislation for public accounting at the present time. There the situation currently stands.

The sections below are devoted to a more detailed analysis of the original draft proposal and the subsequent revision. To aid the reader, a chronology of events and a table comparing the

salient changes in the draft act have been prepared. (Table 3.3.1 and Table 3.3.2.)

B. ORIGINAL PROPOSAL FOR PUBLIC ACCOUNTANCY LEGISLATION

In the position paper accompanying the original draft proposal for legislation Professor Lowrey discussed in general the reasons for such legislation and enunciated three general objectives which he attempted to incorporate in the proposal. These are:

1. To provide for the protection of the public by insuring that those persons to offer services to the public as accountants will, in fact, be competent to do so. The practice of public accountancy would be restricted to those persons who have acquired the requisite knowledge and skill in the area through participation either in formal education programs offered by recognized professional accounting bodies, or by other means and, who have demonstrated their competency by successfully completing a set of examinations and have acquired the necessary practical experience.

2. To provide "bridging" provisions which would permit any person who is licensed under the Act to qualify for membership in any of the recognized professional bodies of accountants subject to certain provisions. In this way, the standards of not only individuals but for the whole field of public accounting in Saskatchewan may become more uniform.

3. To encourage in the longer run, the coming together of various accounting bodies. Such a bridging mechanism may reduce some of the existing barriers between the various professional accounting bodies and if eventual unification is achieved it would eliminate the public confusion over the multiplicity of professional accounting bodies.

Distinguishing between single class and multiple class systems of regulations, Professor Lowrey stated that his legislation adopted

TABLE 3.3.1

SASKATCHEWAN CHRONOLOGY

SPRING 1975	Saskatchewan legislature turns down petitions for Private Members Bills from the Institute of Accredited Public Accountants and the Association of Certified General Accountants.
FALL 1975	Professor D.P. Lowrey, CA, RIA of the University of Regina submits a proposed act to license public accountants and rationale. Accounting bodies discuss and reply to Lowrey proposals.
AUGUST 1976	Professor Lowrey circulates revised Act proposal based on input received from interested parties.
WINTER 1977	Accounting bodies respond to revised Act proposal. Government considers proposals and defers action.

TABLE 3.3.2

SALIENT CHANGES IN SASKATCHEWAN DRAFT PUBLIC ACCOUNTANCY ACTS

	ORIGINAL DRAFT	REVISED DRAFT
DEFINITION OF A PUBLIC ACCOUNTANT	1(f). "public accountant" means a person, who, either alone or in partnership with others, carries on the practice of public accountancy and in connection with that practice offers his services and those of his employees for reward to members of the public.	1(f). "public accountant" means a person, who, either alone or in partnership with others, carries on the practice of public accountancy, and who either alone or in partnership, engages for reward in public practice involving: (i) the performance of services which include preparing, signing, delivery or issuing or causing to be prepared, signed, delivered or issued any financial accounting or related statement, or (ii) the issuance of any written opinion, report or certificate concerning any financial, accounting or related statement, where, by reason of the circumstances or of the signature, stationary or wording employed, it is indicated that such person or partnership acts or purports to act in relation to such statement, opinion, report or certificate as an independent accountant or auditor or as a person or partnership having or purporting to have special knowledge in accounting or auditing matters.

TABLE 3.3.2 cont'd.

	ORIGINAL DRAFT	REVISED DRAFT
DEFINITION OF PUBLIC ACCOUNTANCY.	1(g). "public accountancy" includes:	1(g). "public accountancy" includes:
	(i) the independent verification and, or preparation of any accounting, financial or related statements intended for the public's use which preparation had followed generally acceptable accounting principles, and that the accounting system used to prepare such statements has made such verification and/or preparation possible.	(i) the independent verification and, or preparation of any accounting, financial or related statements intended for, or reasonably expected to be for, the use of the public or other third parties, the preparation of which has followed generally accepted accounting principles and standards for financial statement presentation and the accounting system used to prepare such statements has made such verification and/or preparation possible;
	(ii) preparing or causing to be prepared, signed delivered or issued any accounting, financial or related statements without verification, where a purpose in performing these services is to enhance the credibility or acceptability of such a statement to be released to the public, or other third parties.	(ii) preparing, signing, delivery or issuing or causing to be prepared, signed, delivered or issued any accounting, financial or related statements without verification, where it may be reasonably expected that a purpose in performing these services is to enhance the credibility or acceptability of such statements and where it may reasonably be expected that such statements may be released to the public or other third parties, but does not include preparing or causing to be prepared, any accounting, financial or related statements with or without verification, where such statements are prepared for exclusive internal use and such statements are not released to the public or other third parties.

TABLE 3.3.2 cont'd.

	ORIGINAL DRAFT	REVISED DRAFT
COMPOSITION OF PUBLIC ACCOUNTANTS LICENSING BOARD OF SASKATCHEWAN	3(i). The Board shall consist of fourteen members who may be appointed by the Lieutenant-Governor in Council after being nominated in the following manner:	3(i). The Board shall consist of twelve members, resident in Saskatchewan who may be appointed by the Lieutenant-Governor in Council after being nominated in the following manner:
	(a) two members, who are members of, and nominated by, the Institute of Chartered Accountants of Saskatchewan;	(a) four members, who are members of, and nominated by, the Institute of Chartered Accountants of Saskatchewan;
	(b) two members, who are members of, and nominated by, the Society of Industrial Accountants of Saskatchewan;	(b) one member, who is a member of, and nominated by, the Society of Industrial Accountants of Saskatchewan;
	(c) two members, practising in Saskatchewan, who are members of the Certified General Accountants Association;	(c) one member, who is a member of the Certified General Accountants Association of Canada, nominated by members of the Certified General Accountants Association, resident in Saskatchewan;
	(d) two members, who are members of, and nominated by, the Institute of Accredited Public Accountants of Saskatchewan;	(d) one member, who is a member of, and nominated by, the Institute of Accredited Public Accountants of Saskatchewan;
	(e) one member of the College of Commerce nominated by the Senate of the University of Saskatchewan;	(e) one member of the Faculty of Administration nominated by the Board of Governors of the University of Regina;
	(f) one member of the Faculty of Administration nominated by the Senate of the University of Regina;	(f) one member of the College of Commerce nominated by the Board of Governors of the University of Saskatchewan;
	(g) two members, who are permanent employees of the Government of Saskatchewan nominated by the Minister of Finance; and	(g) one member, who is a permanent employee of the Government of Saskatchewan nominated by the Minister of Finance;
	(h) two members, of the general public nominated by the Minister of Finance.	(h) two members who are nominated by the Minister of Finance.

TABLE 3.3.2 cont'd.

	ORIGINAL DRAFT	REVISED DRAFT
POWERS AND DUTIES OF THE BOARD	12(e). prescribe the standards of education and other qualifications required of applicants for the issue or renewal of a license under this Act, and require the holding of examinations and the setting and marking of examination papers for the purpose of determining the existence of such qualifications.	12(e). prescribe the standards of education, training and other qualifications required of applicants for the issue or renewal of a license under this Act, and may require the holding of examinations and the setting and marking of examination papers for the purpose of determining the existence of such qualifications; except that such standards shall not be lower than those standards of education, training and other qualifications required by any professional accounting association whose members represent 50% or more of those persons licensed under this Act;
	NOT INCLUDED IN ORIGINAL DRAFT	(i) for the purposes of subsection (3) of section 37, evaluate and approve licensed public accountants for the training of students.

TABLE 3.3.2 cont'd.

	ORIGINAL DRAFT	REVISED DRAFT
APPLICATION TO BECOME A REGISTERED STUDENT	37(3). A person employed by a public accountant licensed under this Act may apply to the governing body of The Institute of Chartered Accountants of Saskatchewan or the Society of Industrial Accountants of Saskatchewan to be registered as a registered student of that Institute or Society and the said governing body shall admit such person as a registered student without requiring that such person be or become employed by a practising member of that Institute or Society, provided such person complies with the other requirements of the Institute or Society respecting registered students.	37(3). A person employed by a public accountant who is approved by the Board to train students, licensed under the Act and engaged in public practice, may apply to the governing body of the Institute of Chartered Accountants of Saskatchewan or the Society of Industrial Accountants of Saskatchewan to be registered as a registered student of that Institute or Society and the said governing body shall admit such person as a registered student without requiring that such person be or become employed by a practising member of that Institute or Society, provided such person complies with the other requirements of the Institute or Society respecting registered students.
FILING OF BY-LAWS, RULES AND REGULATIONS MADE UNDER THE ACT.	NOT INCLUDED IN ORIGINAL DRAFT	SEE SECTIONS - 46, 47, 48, 49.

the multi-class regulatory system under which the members of one or more recognized accounting bodies plus persons who are not members of such bodies but who meet the qualifications to practice are given access to the designated field. He states: "First, the legislation guarantees the continued existence of the various professional accounting bodies. Moreover, it does not impinge on their right to grant exclusivity of title and designation to their members. The intent of the legislation is not to regulate the individual accounting bodies, but to regulate the field of public accountancy."

Under the original proposal, Section 1(f) of the draft act defines a public accountant as a person who either alone or in partnership with others, carries on the practice of public accountancy and in connection with that practice offers his services and those of his employees for reward to members of the public and Section 1(g) defines public accountancy to include:

1. the independent verification and/or the preparation of any accounting, financial or related statements intended for the public's use which preparation had followed generally acceptable accounting principles, in that the accounting system used to prepare such statements has made such verification or preparation possible.
2. preparing or causing to prepare, signed, delivered or issued any accounting, financial or related statements without verification, where a purpose in

performing these services is to enhance creditability or acceptability of such a statement to be released to the public, or other third parties.

The act is not intended to affect bookkeepers or persons engaged in tax return preparation, design and installation of accounting systems or accounting and auditing functions for a government department agency. Furthermore, Section 32 of the act specifically excludes any industrial or cost accountant who prepares financial statements solely for management use.

The act establishes a board to perform the licensing function. It envisions a board consisting of fourteen members with the following composition:

Two representatives of the Institute of Chartered Accountants;

Two representatives of the Society of Management Accountants;

Two representatives of the Certified General Accountants Association who must be practising in Saskatchewan;

Two representatives of the Institute of Accredited Public Accountants;

One representative of the College of Commerce nominated by the senate of the University of Saskatchewan;

One representative of the Faculty of Administration nominated by the senate of the University of Regina;

Two representatives who are permanent employees of the Government of Saskatchewan and who are nominated by the Minister of Finance;

Two members of the general public nominated by the Minister of Finance.

Section 12 of the proposed act lists nine powers and duties of the Licensing Board. In addition to issuing, renewing or refusing

licences, maintaining a role of licencees, prescribing fees payable, and exercising disciplinary powers, Section 12 requires the Board to:

> (e) describe the standards of education and other qualifications required of applicants for the issue or renewal of the licence under this act, and require the holding of examinations and the setting and marking of examination papers for the purpose of determining the existence of such qualifications; and
>
> (i) maintain and improve the standards and professional qualifications of licensed public accountants practising as such in Saskatchewan.

The two latter duties are consistent with the envisioned multi-class system of regulation under which non-members of professional associations could meet the qualifications to practise by passing examinations and demonstrating competence.

Section 13 of the proposed act covers the conditions to access. Section 13(1) states:

> Any person, upon application to the Board in the prescribed manner and fee, is entitled to be licensed as a public accountant under this act if the Board is satisfied that such person is of good moral character and has complied with such educational and other requirements and has passed such examinations as the Board from time to time recognizes or prescribes.

Section 13(2) authorizes the Board to establish conditions for exception and Section 13(3) covers applicants from a state or province other than Saskatchewan. The access conditions prescribed

in the sections are consistent with Professor Lowrey's statement that it is his intention not to regulate the individual accounting body, but to regulate the field of public accountancy.

The act includes the commonly found "grandfather" clause in Section 20 which requires that every person engaged in the practice of public accountancy on the date of enactment must obtain a licence from the Board within 180 days if that person wishes to continue in public practice. All those who were in practice as public accountants for at least one year immediately preceding date of enactment are eligible to be licensed under the act. Following the expiration of the 180-day grace period the designations "public accountant" and "licensed public accountant" becomes restricted designations and practice as a public accountant or the holding of oneself out as being licensed as a public accountant become violations under the act.

One of the objectives enunciated by Professor Lowrey was the gradual development of uniformity in the field of public accounting. He foresaw this uniformity coming about through "bridging" provisions as well as through an eventual merger or affiliation of the various professional accounting bodies. The former would permit individuals who were not members of professional associations to become members without undue difficulty while the latter would allow the professional bodies involved to harmonize their training, experience, educational and conduct requirements.

Section 38 of the proposed act outlines the bridging mechanisms. Briefly, the provisions of this section are as follows:

1. A licencee under this act may apply to the Institute of Chartered Accountants of Saskatchewan or the Society of Industrial Accountants of Saskatchewan (now the Society of Management Accountants) for permission to study the course leading to admission into that accounting body and that person shall be accepted without requiring that he become employed by a member of the body.
2. A licencee under this act who has practised public accountancy in the province for at least six years may write the examination for admission into the above accounting bodies and, if successful, shall be admitted as a member of the body.
3. An employee of a licencee under this act may apply to the above accounting body to be registered as a registered student of that body and shall be admitted without requiring that he become employed by a member of the body.

The act makes no explicit provision for licencees who wish to become members of the Certified General Accountants Association or the Institute of Accredited Public Accountants, nor is there an explicit reference in the proposed act to merger or affiliation of the professional accounting bodies at some future point.

Finally, in respect to the division of functions in the area of

licencee discipline, the act states that in cases where a professional accounting association intends to initiate disciplinary proceedings with respect to a member who is also a licencee the association must serve a written notice to the Board thirty days prior to initiating its own procedures. If the Board decides that it intends to initiate its own disciplinary proceedings the professional association is enjoined from doing so until such time as all disciplinary action and all appeals and reviews under the act have been exhausted. Only if the Board does not intend to initiate disciplinary proceedings is the professional association free to proceed.

C. REVISED PROPOSAL FOR LEGISLATION

The revised draft act that was presented to the Government of Saskatchewan in the Fall of 1976 contained a number of changes. While many of these changes improved the wording and organization of the sections of the act, a number made substantive changes to the intent and probable effect of the legislation. Principally, these changes occur in the definition of a Public Accountant, the definition of Public Accountancy, the composition of the Public Accountancy Licensing Board, the powers and duties of the Board, and the bridging provisions. For ease of comparison, the appropriate sections of the original and revised draft are presented in Table 3.3.2. Below is a list of the most important changes found in the draft revision.

Under the definition of Public Accountant, the revised draft parallels closely the definition found in The Public Accountancy Act of Ontario (R.S.O. 1970, c. 373). Under the revision a public accountant must act or prepare to act in relation to a financial statement, opinion, report or certificate in the manner of an independent accountant or auditor whereby he would be assumed to be lending credibility to said financial statement and not simply carrying on as the practice of public accountancy for reward.

The definition of Public Accountancy is expanded both for verified and unverified accounting of financial or related statements to cover not only those cases in which such statements are intended for use of the public or other third parties but also those cases in which such statements may take on a public character or, "...where it may reasonably be expected that such statements may be released to the public or other third parties."

The proposed Public Accountants Licensing Board of Saskatchewan is decreased in size from fourteen to twelve members. Its composition is changed from one of equal representation of the accounting associations to one where four of the twelve members are nominated by the Institute of Chartered Accountants, one each by the Society of Industrial Accountants (now Society of Management Accountants), the Certified General Accountants Association and the Institute of Accredited Public Accountants. Representation from the Government of Saskatchewan is reduced from two to one and the requirement that the two members of the Board appointed by the Minister of

Finance be "of the general public" is dropped.

The section of the draft act describing the powers and duties of the Board has been amended as follows. In Section 12(e) the holding of examinations and setting and marking of examination papers for the purposes of determining the existence of applicant qualifications has been reduced from a requirement to an option through the introduction of the word "may". The standards which the Board can adopt have also been qualified with the inclusion of the clause:

> ...except that such standards shall not be lower than those standards of education, training and other qualifications required by any professional accounting association whose members represent 50% or more of those persons licensed under this act.

The membership figures for the four accounting associations in the province would suggest that the professional accounting association whose members represented 50% or more of those persons licensed under the act would be the Institute of Chartered Accountants of Saskatchewan.

The other changes to the powers and duties of the Board include the elimination of the duty to prosecute defences under the act and the introduction of a qualification stemming from a change in the bridging provision for the training of students.

In Section 37 covering bridging provisions, those provisions applying to students have been restricted to individuals who are employed by public accountants who are approved by the Board to train students and are licensed under the act and engaged in public practice.

What this would mean in practice, is that individuals employed by licencees, who because of the nature of their practice could not receive approval for the training of students, would be effectively barred from themselves becoming licencees under the bridging provisions in the act.

In conjunction with the changes in Section 12(e) governing the applicable standards for potential licencees, the changes in the bridging provision for students could conceivably have a negative affect on those individuals working for non-approved licencees.

D. REACTION OF THE PROFESSIONAL ACCOUNTING ASSOCIATION TO THE REVISED DRAFT

According to Professor Lowrey the changes in the revised draft resulted from public discussion of the original proposal. Lowrey took the submissions of the various parties and incorporated them in the form of the changes previously discussed. The results did not find strong support either among the Chartered Accountants, Certified General Accountants or Accredited Public Accountants in the province. The Chartered Accountants, while supportive of the concept of public accounting legislation, did not support the revisions. They felt that they should be exempted from the licensing requirements. The provision of the Bill that would have excluded CA's not in public practice from automatic licensing was another point of contention. The Certified General Accountants wrote to the Minister of Finance expressing their lack of support

for the revisions. The chairman of their legislation committee stated:

> In its present draft form the Bill effectively creates a monopoly for the Chartered Accountants and can only restrict service and increase professional fees in the province. Specifically Section 12(e) of the draft Bill has created an absolute monopoly for Chartered Accountants based solely on practising membership numbers. The Bill is absolute in this area, and permits no relief.

Specific objections of the Certified General Accountants revolved around the revised definition of public accounting, the exclusion of bookkeeping and tax preparation services from the definition and the composition of the licensing board. Further, the CGA's were not happy with the bridging provision of the revised act which they felt could create a "closed shop" in public accounting. The requirement that only approved offices be permitted to train candidates for public accounting licences also evoked concern. The Accredited Public Accountants felt that the revised licensing provisions would be the death knell of their organization.

Although the original impetus for the development of licensing legislation came from the then Minister of Finance, the revised version was presented to a new incumbent who, noting the lack of agreement from the professional accounting bodies over the proposed amended legislation,did not actively support its passage. While the revised draft went to the Legislative Review Committee where several amendments were added, no action on the Bill has been taken and it continues to sit in committee. Mr. Lowrey mentioned that he did not expect any further action on public accounting legislation in Saskatchewan in the near future.

CHAPTER 3.4

PUBLIC ACCOUNTING IN ALBERTA

A. INTRODUCTION

The public accounting field is unregulated in the province of Alberta. Neither The Company's Act R.S.A., 1973, c. 60 nor The Securities Act R.S.A., 1970, c. 333 place any restriction on individuals performing the audit functions for companies registered in Alberta. Efforts to introduce restrictions into The Credit Union's Act and The School's Act were successfully opposed by the Certified General Accountants Association in the province. In spite of the absence of regulatory legislation in the province, discussions on the merits of such legislation have been frequent. In 1972, the Special Committee of the Legislative Assembly of Alberta on Professions and Occupations (hereinafter called the Chickak Committee after its chairwoman) accepted briefs from professional and occupational groups on broad questions of occupational licensure and regulation. An interim report was released in April of 1973 and the final report was tabled in the legislature in December of 1973. A discussion of the contents of the report and the submissions of the accounting bodies in the province follows.

More recently, the Certified General Accountants Association's efforts to obtain incorporation by private members bill occasioned considerable debate. The effort was opposed by both the Chartered Accountants and the Registered Industrial Accountants in the province,

and no action has been taken by the province pending a decision on the Chichak Report's recommendations.

Table 3.4.1 provides a measure of the relative sizes of the professional accounting associations in the province. However, the figures in the tables do not give a full picture of the composition and growth of the major accounting associations. According to the Institute of Chartered Accountants of Alberta, the pattern of practice of Alberta CA's is similar to that found in Ontario. There are some 250 practising offices in the province and all national firms are represented although some are rather small in comparison to their national size. An influx of CA's into public practice from elsewhere in Canada, especially CA's with the large accounting firms has recently swelled the ranks of public practitioners in the province. Moreover, there is a difference between the two major cities in Alberta: Calgary and Edmonton. Edmonton, not being a headquarters city, has a proportionately larger number of large local firms, at least one with eighty CA's. Calgary, the head office city in Alberta, supports the large national firm offices. The number of registered students in the Alberta Institute has not been growing appreciably since 1968 and has shown a decline in the period 1970 to 1974. New student intake also declined in 1977 dropping from 300 students in 1976 to 245 new registrants in 1977. According to the Institute, 80% to 85% of the CA student intake comes from the Bachelor of Commerce program of Alberta universities. Two-thirds of Bachelor of Commerce majors

TABLE 3.4.1

Public Practitioners in Alberta (1977)

	Total Members	Members in Public Practice
Chartered Accountants	2600	1500
Certified General Accountants	270	22
Accredited Public Accountants		63

in accounting enter the CA program down from a previous high of 90% to 95%. Accounting majors in turn make up one-half of all Bachelor of Commerce students.

The Executive Director of the CGA Association, Prairie Region, gave some additional facts about that association's membership in Alberta. Although membership numbers, especially those of public practitioners, are very small in relation to CA membership, Mr. Brown indicated that his association has been experiencing growth. The number of CGA's in public practice has grown from three in 1975 to twenty-two in 1977 representing eleven or twelve firms in the province. The number of CGA students has grown from eighty in 1969 to 1,300 in 1977. Ninety per cent of the students come from the work environment and only 10% enter the program directly from high school. The association stated that its members tended to practise in smaller centres and that the type of work performed by them has a heavy tax emphasis (amounting to 50% of work done) with a lesser amount of work in auditing and accounting services. Clients tend to be local in nature.

In other respects, the public accounting picture in Alberta is similar to that in Ontario. Both the Institute of Chartered Accountants and the Certified General Accountants Association are members of their respective national bodies and as such follow national guidelines on admissions, education, training, examinations, and professional development. Differences in the educational

program are the result of local needs. The CA's do not offer a school of accountancy along the lines of Ontario, but rather have developed four course modules in tax, auditing, financial reporting and special topics used in all four western provinces and commonly called the Western Provinces Course of Instruction. The course, along with in-depth examinations,act as a screen for candidates planning to write the Uniform Final Examination. On balance, the course material places a somewhat lower emphasis on auditing than found in Ontario reflecting the type of practice of CA's in the west. Students gain their practical experience in some 125 approved offices of which twenty offices handle roughly 80% of the students. These offices undergo a tri-annual review of their practice standards and it is expected that a recent tightening of those standards may eliminate some smaller offices. Students are required to "article" for a minimum term of twenty-four months.

The CGA educational program is basically the same as that found in Ontario. The Prairie Region has developed two additional practice sets in auditing and accounting that supplement the national course. Monitoring of students' practical experience is based on a national policy but there is no insistence that undergraduates train with public practitioners. The examinations in the individual courses given to CGA undergraduates are national in scope.

Incorporated professionals are legal in the province of Alberta. A Professional Corporation's Act was passed in 1976 and allows

professional individuals to incorporate themselves. The liability that an individual can be carrying on his professional practice continues to reside in the individual and not in the corporation, and ownership of the professional corporation is restricted to professionals. At the time of writing, 128 "firms" of chartered accountants have become professional corporations with thirty-one pending. Additional information on incorporated professionals in Alberta is available from the relevant statutes.

Finally, it is worth noting that the Institute of Chartered Accountants in the province is planning an advertising campaign to inform the public at large about the services provided by its members as well as a series of seminars with bankers and financial institutions to inform the latter group of the type of work done.

B. THE CHARTERED ACCOUNTANTS ACT

The Chartered Accountants Act, R.S.A. 1970, c. 42 establishes the Institute of Chartered Accountants of Alberta and sets out its duties and powers. The Act is similar to that found in Ontario yet different in that it incorporates a number of features whose origin can be traced to the origin of the Institute itself. The Institute of Chartered Accountants originally operated as a part of the Univeristy of Alberta. Hence, the structure of the Institute and of the Act is determined in part by the structure of the

university and accounts for the presence of the University Co-ordinating Council as an element in the training and examination process. In fact, the association with the University of Alberta, as embodied in the Act, sets out an optional route to membership.

Section 10 of the Act which sets out the powers of the Institute's Council states:

> (2) The academic standing and examination of candidates for admission to membership in the Institute shall be under the control of the Universities Co-ordinating Council.
>
> (3) The Institute shall enter into an agreement with the Universities Co-ordinating Council for the conduct of such examinations.
>
> (4) The subjects of all examinations under this Act shall be such as are prescribed by the Universities Co-ordinating Council.
>
> (5) A person who has fulfilled the requirements prescribed by sub-section (1) and who has passed the examinations prescribed by sub-section (4) may apply for membership to the Institute.

The Universities Act, R.S.A. 1970, c. 378, s. 61 establishes the powers of the Universities Co-ordinating Council. It empowers the Council to enter into such arrangements with the Institute or other body as the Council considers desirable in order to fulfill its powers, duties and functions under the Act. It also empowers the Council to establish and appoint a Board of Examiners and to

delegate to the Board of Examiners those powers, duties and functions which the Council sees fit. In the chartered accounting field the Board of Examiners in Chartered Accountancy supervise the setting of examinations for the four subject modules referred to above as well as the Uniform Final Examination. According to the Institute, an increasing percentage of the Board's function has been taken over by the Institute's staff with the Board acting as a board of appeal. In other words, at the present time, the setting and marking of examinations are effectively the responsibility of the Institute.

Section 13 of The Chartered Accountants Act deals with educational qualifications. It states:

> 13(1) A candidate for admission to membership in the Institute who satisfies the Universities Co-ordinating Council and whose educational qualifications at the time that they were acquired are at least the equivalent to those required for admission to membership in the Institute at that time shall be deemed to have satisfactory educational qualifications for admission to membership to the Institute.
>
> (2) The Universities Co-ordinating Council shall issue a certificate certifying compliance with sub-section (1) to a candidate who has satisfied the Universities Co-ordinating Council with regard to his educational qualifications under that sub-section. In the case of candidates who does not meet the educational qualifications stated under sub-section (1) the Universities Co-ordinating Council may prescribe additional courses or examinations as it sees fit.

Section 14 of the Act establishes a Board known as the Accountants Experience Appraisal Board composed of three members, one each recommended by the Institute, the Universities Co-ordinating Council and the Minister whose duty it is to judge the practical experience

of a person who seeks admission to membership in the Institute and who has not fulfilled the requirements of Section 10 of the Act. The Experience Appraisal Board has not met in the last five to seven years and no members are currently appointed. Again, the Board is intended to act as an appeal board for those seeking CA membership who have trained in non-authorized offices or perhaps in other fields of accounting.

Apart from their historical origin, both the Board of Examiners and the Experience Appraisal Board were perceived as autonomous bodies who would review the qualifications of candidates seeking admission to the Institute who for some reason had not followed the typical path to Institute membership. Over time, the increasing specificity of the Institute's educational and training requirements has made at least the latter of these two essentially superfluous. It is important to recall in this context that The Chartered Accountants Act is not an Act intended to regulate the practice of public accounting in Alberta. Section 51 of the Act makes this explicit by stating that:

> Nothing in this Act affects or interferes with the right of a person not a member of the Institute to practise as an accountant in Alberta, or with the right of a person not residing or having an office within Alberta to use any designation as accountant.

C. THE CHICHAK REPORT ON PROFESSIONS AND OCCUPATIONS

Efforts to regulate the field of public accounting in Alberta

have taken a number of different turns. According to the Institute of Chartered Accountants, it has taken several initiatives, first in 1950 and 1951, again in 1955 and again in 1965. None of these met with success. In 1972 the Chichak Committee was formed to examine the professions in the province. Within the last year, the Institute met with the Attorney General to discuss the possibility of regulation. The discussions revolved around the existence of a "problem" in the area of public accounting and the availability of evidence of such a problem that could be used as an argument for the enactment of legislation. Since then, no further initiatives have been taken in the area of licensing.

The work of the Chichak Committee is interesting because, like the Professional Organizations Committee, it provided an opportunity for the professions in the province to state their position on licensing and other matters. The terms of reference of the Committee required it to:

a) conduct a review of the existing Alberta Legislation pertaining to 1) regulations of professions and occupations and 2) licensing thereof;

b) examine generally the policies and principles underlying such legislation, particularly in relation to those professions and occupations that have been given the power of self-regulation and licensing as distinguished from those regulated and licensed by the government; and

c) hear representations from associations incorporated under such legislation or that are representative members of a professions or occupation, whether it is presently subject to regulation by statute or not.

The Committee prepared a very interesting and thought provoking report that focused on five areas in the rationalization of the

development of professions and occupations,namely, criteria for self-government, certification and licensing, professional conduct, discipline and complaint procedures, continuing education and accountability. In its final report it listed twenty-eight recommendations covering all five areas that present broad guidelines under which professional regulation ought to evolve. The arguments on which those recommendations are based are too lengthy to repeat in this report and the reader is recommended to seek the report of the Committee for an analysis of its arguments as well as the appended recommendations.

Of interest to this study is the submission of the Institute of Chartered Accountants. The CA's maintained that their members performed almost all audit work, both corporate and government in Alberta. They argued that this preeminence was achieved without special regulatory legislation; it is based solely on the reputation and stature of the Chartered Accounting profession. The Institute went on to say that:

> It is unlikely that the introduction of regulatory legislation would have a material effect on institute members in the near future. Accordingly, from a "vested interest" point of view the Institute does not require or need regulatory legislation. [16]

The Institute went on to state that it was greatly concerned about the absence of (accounting) legislation as a safeguard to the public interest. The major causes of concern were the proliferation of accounting bodies, the lack of protection afforded small businessmen and individuals, confusion of the public, and the failure of public education resulting from the confusion about the

work of accountants. They stated:

> The increasing number of persons offering their services confused the general public and adds to their inability to obtain qualified assistance in a manner other than by sheer chance. [17]

The Institute's brief discussed alternative forms of accounting legislation. Distinguishing between permissive or non-regulatory legislation such as currently exists in Alberta and regulatory legislation wherein the practice of public accounting is reserved to licensees, the Institute further identified two types of regulatory legislation. The former a one class system of regulation, wherein the public accounting field is reserved to members of a designated organization; the latter a multiple class system of regulation where under licences to practice are available to qualifying individuals.

The form of accounting legislation recommended is that of the single class type. The Institute states:

> It is not without some reluctance that this Institute recommends to the Legislative Committee on Professions and Occupations that the form of legislation to govern the accounting profession in Alberta should be the single class form of legislation administered by the Chartered Accountants. Success enjoyed by the members of the Institute under the present non-regulatory legislation will not likely be improved by single class form of legislation and flexibility will be lost. However, we believe the public interest should come first and can only be met by a single, strong professional body. [18]

In making this recommendation, the Institute recognized three main problems:

a) that safeguards are required to offset single

class legislation;

b) that there must be a definition of public accounting, and

c) that there are transition problems that effect persons presently practising public accounting but not members of the designated body.

As a solution for the first problem, the Institute recommends lay representation on the Council and on the Conduct and Discipline Committees of the Institute. For the second, the definition of public accounting, it recommends a definition quite similar to that found in The Public Accountancy Act of Ontario. To cover the transition problem, the Institute recommends that those not eligible for membership in the Institute but practising in the field of public accounting be licensed by the Institute and be required to conform with the ethics and standards of conduct similar to those set forth by the Institute for its own members. The licensing of this group would be done by a committee of the Institute on which there would be both government and lay representation. Only those who are fully qualified Chartered Accountants would be allowed to practise public accounting after a certain date.

The other professional accounting associations also submitted briefs to the Chichak Committee. Both the Certified General Accountants Association of Alberta and the Society of Industrial Accountants of Alberta (now the Society of Management Accountants) supported the concept of some form of regulatory legislation.

However, there was considerable divergence on the type of legislation that would be acceptable. The CGA Association saw such legislation as providing the framework for unification of the present accounting groups or for the establishment of a set of standards or examinations for all aspirants to the licence. The Society of Industrial Accountants felt that the only accounting specialty that would warrant legislative restrictions on qualifications was that of public auditing. They recommended the establishment of a qualification board to govern the public auditing specialty. The Society of Industrial Accountants stated that "restrictions on the qualifications of those entering the specialty of public accounting would require the public to obtain the services of persons holding such specific qualifications... requiring the public to obtain such services is not in the public interest, and this is particularly so in rural communities, where such services frequently are not available."[19]

The submissions to the Chichak Committee from the professional accounting associations clearly point out the divergence of interests of these associations. While there is some agreement on the need for legislation covering the accounting field, there is by no means agreement on the form that such legislation should take, nor on the definition of the services covered by such legislation. It is the impression of the author that this disagreement continues up to the present and that it is one of the reasons that no action has been taken on regulatory legislation in Alberta.

CHAPTER 3.5

PUBLIC ACCOUNTING IN BRITISH COLUMBIA

A. INTRODUCTION

In the two preceding chapters, the unregulated environment for public accounting found in Saskatchewan and Alberta was described in some detail. British Columbia's regulatory environment can best be described as mixed. There are some restrictions on auditing, set out in the recently amended B.C. Companies Act, R.S.B.C. 1973, c. 18. These will be described in detail in Section B below. However, there are no restrictions in the broader areas of public accounting covering review and non-review assignments performed by accountants in which credibility is added to financial information by the association of the accountant with the information. Tax work, bookkeeping and the actual preparation of unsigned financial statements is unregulated in B.C. as it is in Ontario.

The situation in British Columbia differs from that in Ontario not only in the regulatory field but also in size, relative importance and interaction of the professional accounting associations. A brief profile of the three major groups will help to clarify this point. The Institute of Chartered Accountants was incorporated by an Act of the provincial legislature in 1905. The Act restricts usage of the designations "CA, ACA and FCA" in the province and provides the Institute with the customary powers of self-regulation: education and discipline. Current membership in the Institute

stands at 2,557 (as of March 31st, 1977) up from 2,432 in 1974. There are some 300 practising offices in the province, a high percentage of which are in the Vancouver area. All of the major national firms are represented.[20] At the present time, the membership of the Institute is roughly equally divided between those in public practice and those in industry, government and academia.

The Certified General Accountants Association of B.C. was incorporated in the province in 1951, also by Act of the provincial legislature, and given the right of self-regulation. The Act, 9 Eliz. II, 1960, ch. 47 restricts usage of the designation Certified General Accountant to members of the Association and prohibits use in B.C. of the designation "certified public accountant" or "certified public auditor". (Section 15(3)). Section 19 of the Act leaves the right to practise as an accountant unaffected:

> Nothing in this Act shall affect or interfere with the right of any person not a member of the Association to practise as an accountant or auditor in British Columbia.

Membership in the Association stood at 1,459 at the end of 1977 up from 1,144 in 1974. At the end of 1977 there were 175 firms in public practice with 313 certificated members and 447 students.

The Society of Management Accountants (formerly the Society of Industrial Accountants) is the smallest of the major professional groups in the province with 811 members at the end of 1977, up from 521 in 1974. The SMA's members typically do not practise

public accounting or offer their services to the public. There are, of course, some exceptions to this statement, principally among those members who are dually qualified (ie. both RIA's and CA's, etc.)

From these figures, one important conclusion may be drawn. The number of members of the CGA Association who are in public practice relative to the total membership of that Association is quite large compared to membership figures from other provinces. Moreover, the number of CGA firms is large relative to the number of practising CA offices in the province: 154 versus 300. Again, this relationship is striking when compared to the figures presented for Alberta. (It is, of course, also striking when compared to the figures for Ontario; however, the restrictions in Ontario's Public Accountancy Act explain the difference.)

A part of the explanation for the relative size of the professional associations lies in the educational field: British Columbia is the "home" of the CGA Association's educational program. The Association's 1977-78 calendar describes the situation as follows:

> Since the beginning, the objectives and curriculum of the Education program of the Association have been established in consultation with the Faculty of Commerce and Business Administration of the University of British Columbia.

The negotiations between the CGA's and U.B.C. began in 1948 and led to the development (in 1951) and subsequent refinement of a correspondence/lecture program of courses that has been adopted by the Association on a national basis. In 1956 Ontario contracted

to adopt the program of studies and Quebec followed suit in 1958.

Both the course and the examinations are now national in scope. The National Co-ordinating Council on Education and the National Board of Examiners operate through the national office of the Association which is located in Vancouver. The ties between the CGA Association and U.B.C. remain close. The Association offers its Vancouver lecture program through evening courses at U.B.C. and faculty from the University have served in elective positions in the B.C. Association; the latest being Dr. George Gorelik who was President of the Association in 1976. The Association and U.B.C. co-operate in the field of professional development and research sponsorship. The CGA designation is recognized by the University as an undergraduate degree equivalent.

The foregoing should not be read to mean that only the CGA's have developed close working relationships with B.C. universities, but rather to show the extent to which this Association's educational program has evolved in conjunction with a particular institution.

Students enrolled in the CGA program of studies numbered 2,767 in 1975, up from 2,380 in 1974. Of these, some 456 were working in the public practice field, presumably in both CA and CGA offices throughout the province.

The Institute of Chartered Accountants' Educational program is similar but not identical to that found in Ontario. The Institute uses the Western course of study, dispensing with the School of Accountancy in favour of a series of four courses in the areas of auditing procedures, taxation, audit concepts and techniques and financial accounting and reporting.

The registration provisions also differ somewhat from those found in Ontario. First, the Institute recognizes two classes of students: registered and interim. The former has fulfilled all admission requirements while the latter must have a minimum of sixty semester credits toward a university degree and employment with an approved firm of CA's. The interim student is essentially enrolled in a co-operative program for a maximum of five years during which the student must be employed a minimum of four consecutive months full-time during each sixteen-month period.

Second, application for registration is accepted from individuals who comply with the following requirements:

a) a baccalaureate or higher degree from a recognized university;

b) 15 semester credits in financial accounting, mathematics, economics and one elective;

c) full-time employment with an approved CA firm;

d) Canadian citizenship or landed immigrant status.

However, the registered student is required to take additional university credit courses following registration under the guidance

of the Institute and in prescribed areas. Exemptions are granted for work done. The number of additional credits required is forty-one. (For details see the I.C.A.B.C. Student Handbook listed in the Bibliography.)

The practical experience requirement of the B.C. Institute is set at three years with two years as the minimum possible. One hundred and twenty-five offices were approved for training as of June, 1977. In March of 1977 the Institute had some 682 registered students and 28 interim students, compared with 631 and 60 respectively in 1974. The majority of the recent enrollees are graduates of the Bachelor of Commerce Program at U.B.C. - 35% are B. Comm. (Accounting) grads., 7% are B. Comm. (general) and 8% are Licentiates in Accounting from U.B.C. - while the Bachelor of Arts in Economics totals another 12% of B.C. registrants.

In their other activities, the Institute and the Association resemble their Ontario counterparts. The committee systems and disciplinary activity are similar. In the disciplinary field the CGA Association handled eight cases during the latter part of 1975 and the first five months of 1976: two of the eight dealt with fees; two more dealt with advertising and the remainder concerned unprofessional conduct. The Institute's Professional Conduct Committee concluded its investigation of thirty-six matters brought before it by members or the public in the year ending March 31, 1977. Of the thirty-six enquiries, eleven were of a professionally technical matter and twenty-five resulted in investigation of ethical matters.

Three matters were referred to the Professional Conduct Enquiry Board.

In one area the professional associations varied significantly from Ontario practice and that area was institutional advertising. Both the CGA Association and Institute ran advertising in the newspapers of the province describing the kinds of work done by their members in public practice. The Institute's advertising campaign was described in the May, 1977 issue of News & Views, the provincial newsletter as follows:

> Over an exposure period of six weeks, each (of 3) ad(s) appeared twice in the daily newspapers of the province. Council is now assessing the program which will be presented to the annual meeting for discussion and further action.
>
> In addition to the institutional advertising, a smaller ad reproducing the "yellow page" information in the phone book was prepared and run for 10 weeks in all the dailies plus selected weeklies. This program, too, is being assessed.
>
> In addition, CA's in Kamloops - under a special pilot program approved by Institute offices - approved a larger ad for that city to which the names of the Chartered Accountant firms in the area were appended. A report on the Kamloops experience is being prepared for discussion at the Institute level and at the annual meeting.

This is the second time that the Institute has undertaken an institutional advertising campaign. According to the Executive Director of the Institute a similar and "quite extensive" campaign was run several years earlier and met with approval from members.

B. CHANGES TO THE BRITISH COLUMBIA COMPANIES ACT

The statute governing incorporated companies was amended in 1973. The changes to the Act of interest here revolve around the specification of auditor qualifications. Similar specifications have also been included in the statute governing the operation of insurance companies in the province.

The Companies Act, 22-22 Eliz. II, ch. 18, s. 201(1) states that:

> 201(1) - Subject to section 202, every company shall have an auditor.

and Section 202(1) states that:

> 202(1) - Subject to subsection (5) of Section 201, if all the members of a company that is not a reporting company consent in writing to a resolution waiving the appointment of an auditor, the company is not required to appoint an auditor and the provisions of this part (Part 6 Audits) except this section do not apply to it.

Section 203 states the professional qualifications required:

> 203 - The auditor of a reporting company shall be a person who is a member, or a partnership whose partners are members, in good standing of The Canadian Institute of Chartered Accountants or the Certified General Accountants Association of British Columbia.

For the purposes of the Act, a reporting company is defined as:

> "...a corporation incorporated by or under an act of the Legislature
> (a) that has any of its securities listed for trading on any stock exchange wheresoever situate; or
> (b) that is ordered by the (securities) commission to be a reporting company; or
> (c) that:
> (i) was or was deemed to be a public company immediately before the coming into force of this Act; or

(ii) had obtained an exemption order, under Section 38(a) of the Act repealed by this Act, where the exemption order was in effect immediately before the coming into force of this Act; or

(iii) with respect to any of its securities, files a prospectus with the (securities) commission and obtains a receipt therefor; or

(iv) became an amalgamated company after the coming into force of this Act if one of the amalgamated companies was, at the time of the amalgamation, a reporting company, unless the (securities) commission orders that it is not a reporting company.

Thus, in most instances "reporting company" could be deemed to be synonymous with a company that has publicly traded shares. At the present time, then, only public companies require an audit and only CA's and CGA's can perform such an audit, subject to the amendment discussed below.

The regulation of auditing under The B.C. Companies Act is, thus, both narrower than is the case in Ontario since only "public companies" are included, not all companies over a certain size in sales and assets, and broader than the provisions of The Public Accountancy Act of Ontario since both CA's and CGA's are permitted to audit firms with publicly traded shares.

The Act makes no reference to the non-audit functions of the public accountant such as reviews of financial statements or the imparting of credibility to financial information and such functions can be carried out by anyone.

In spite of the apparent limited scope of these provisions, the government felt that the prohibition of auditing to anyone but

those named in Section 203 was unduly restrictive and in 1974 the Act was amended again to substitute a new section 203 and two new subsections 203A and B. The new provision provides for certification of auditors who are neither members of the CICA nor the CGAABC. The substituted section 203 now states:

> Professional qualifications - The auditor of a reporting company shall be
> (a) a person who is a member, or a partnership whose partners are members, in good standing of The Canadian Institute of Chartered Accountants, or the Certified General Accountants Association of British Columbia; or
> (b) a person who is certified by the board established under section 203A.

The two new subsections state:

> 203A. Auditor certification board.
> (1) For the purposes of this section and section 203B, "board" means the Auditor Certification Board established under this section.
>
> (2) There is established an Auditor Certification Board comprised of:
> (a) one person who is a member of The Canadian Institute of Chartered Accountants;
> (b) one person who is a member of the Certified General Accountants Association of British Columbia;
> (c) one person who is a member of the Society of Industrial Accountants of British Columbia; and
> (d) not more than two other persons, all of whom shall be appointed by the Lieutenant-Governor in Council upon such terms and conditions as he may prescribe.
>
> (3) Unless fixed at a higher number by the board, two members of the board constitute a quorum.
>
> (4) The board may elect one of its members as chairman, establish its own procedures, and prescribe such rules as it considers advisable to carry out its function.
>
> (5) The board may, with the prior approval of the Lieutenant-Governor in Council and pursuant to The Public Service Act, employ such persons as it considers necessary to carry out its function.

(6) Members of the board shall serve without remuneration, but the Lieutenant-Governor in Council may fix a per diem allowance to be payable to each member, and each member shall be reimbursed for reasonable travelling and out-of-pocket expenses, as certified by the chairman of the board, that are necessarily incurred by each member in discharging his duties.

203B. Board function and liability.

(1) The function of the board is to receive applications from persons who apply to be certified as auditors for the purposes of section 203 and to certify those persons where, in the board's opinion, they have the qualifications necessary to be auditors for the purposes of this Act.

(2) The board may take into consideration the area of the province in which an applicant carries on or intends to carry on business and may certify an applicant subject to such terms and conditions as it considers advisable.

(3) No member of the board is liable for any loss or damage suffered by any person by reason of anything in good faith done or not done in the exercise or purported exercise of any power or performance of any duty under sections 203 to 203B.

The original members of the Board were appointed by Order in Council in August of 1974. The two other members specified under Section 203A, are the Registrar of Companies and the Superintendent of Brokers.

One of the individuals interviewed stated that the Auditor Certification Board (ACB) had been included in the legislation as a "preventitive measure". However, the ACB has not found itself overwhelmed with work. It has prepared a comprehensive application form/questionnaire, a set of guidelines to assist individuals in making applications to the Board and a code of professional ethics for auditors certificated by the Board. (See Bibliography for these materials.)

Whether from a lack of qualified applicants or as a result of the "restricted" definition of a reporting company, the numbers applying to the Board have been small. Ten to fifteen individuals have applied in the last three years (there was even some confusion as to the exact number who had applied) and only one applicant in the last year. The latter was an RIA who received the auditor certificate although he had no audit clients.

The Accredited Public Accountants, numbering approximately thirty, attempted to get certification as a group but were turned down and asked to re-apply individually -- so far none have done so.

One member of the ACB stated that he felt that the Board provided an alternative route to audit practice and that it was low cost alternative that should be retained.

The guidelines prepared by the Board reflect the judgment that a certain standard should be set. In the area of experience they call for three of the preceding five years having been spent in the practice of public accounting in B.C. or similar acceptable experience elsewhere. Technical knowledge is required of applicants in the areas of auditing, taxation, accounting, commercial law and federal and provincial statute law. Knowledge of GAAP's and the ability to complete audits must also be demonstrated. Applicants who receive the audit certificate issued by the Board normally have them annually renewed unless there are problems.

The possibility of extending the function of the Board to cover individuals (and firms) currently auditing societies, co-operatives and credit unions has been discussed. The numbers are significant. B.C. has some 18,000 societies and 700 co-operatives, a large number of which are apparently being audited by individuals without any qualifications. The impact that amendments to these statutes would have on the guidelines and workload of the ACB was not known.

Other legislative action was not being contemplated in the province at the time that the interviews were conducted by the author (August 1977). Changes in the definition of a "reporting company" or in the scope of restrictions on public accounting practice were not under active consideration. Public Accountancy legislation with definitions similar to that found in the Ontario Public Accountancy Act and that recommended for Saskatchewan was not on the agenda for either the Institute or the CGA Association.

However, merger or "rationalization" of the profession had been under active consideration and the following section explains the events in greater detail.

C. MERGER DISCUSSIONS

From time to time, the three major professional accounting bodies in this country have undertaken discussions, the purpose of which is to consider the possibilities for some form of merger, unification or "rationalization" of the profession in order to

create a single professional body of accountants similar to that found in the professions of law and medicine. In some instances these discussions are prompted by the recognition that costly duplication in the areas of education, ethics and administration could be avoided. In other instances such discussions grew out of a desire to promote regulatory legislation or as a response to the urgings of a provincial legislature eager to force co-operation following the passage of licensing statutes.

So far in this paper there have been discussions of merger talks in Quebec. Below is a review of such negotiations in British Columbia. The issues are again essentially the same. The impetus, according to various sources in B.C., was the concern on the part of the professional bodies that the NDP government in power in the province at the time would force some form of supervision on the accountants, against their will and in a form not of their choosing. The results of these protracted negotiations are also familiar -- no action.

The review of the merger discussions is taken from three primary sources: a report on the events prepared by the CGA Association entitled "Rationalization of the Accounting Profession in British Columbia", articles appearing in the house organ of the Institute, News & Views, and interviews with members and staff of both groups.[21]

On August 8, 1973, the presidents of the Association, Institute and Society met for the first time in several years to discuss

"rationalization". Out of the meeting came the Inter-profession Ad Hoc Committee on Rationalization of the Accounting Profession in the Province of British Columbia. This committee, consisting of two members (one from public practice, one not from public practice in the case of the Institute and the Association) from each body met regularly to prepare a report addressing the following terms of reference:

> The purpose of this Committee in general terms is, therefore, to attest to (the assumption that the competency of all our members and the profession in general could be enhanced by a singular standard and objective) and, if confirmed, to recommend ways of implementation. The Committee will consider and make recommendations on the following as they apply to the Province of British Columbia only:
>
> 1. Is it desirable and possible that all Professional Accountants be governed by singular (a) By-laws; (b) Code of Ethics and (c) rules of professional conduct.
>
> 2. Is it desirable and possible that a singular educational program could be developed that would satisfy the academic requirements of all Professional Accountants.
>
> 3. Is it desirable and possible that the profession should have a singular effort for (a) legislative representation; (b) legislative liaison; (c) public relations program; (d) pronouncements to the public regarding current events and legislation, both foreign and domestic.
>
> 4. What type of organizations would be needed to accomplish what was determined to be desirable and possible.
>   (a) What administrative structure would be needed?
>   (b) What cost factors would be involved?
>   (c) How would this organization be funded?
>
> 5. Consider and make recommendations on such other factors as the Committee may feel are germane to the proper resolution and rationalization of any apparent inefficiencies of the accounting profession in British Columbia, and any other factors that would enhance the ability of Professional Accountants in their service to the community.

The Ad Hoc Committee reported to the Steering Committee of presidents of the groups in January of 1975. They made twelve recommendations (the full report is reproduced in the document indicated above).

1. The rationalization of the accounting profession in B.C. should take the form of the unification of the I.C.A.B.C., the C.G.A.A.B.C. and the S.I.A.B.C. Unification of the accounting bodies is possible, desirable and practical. It should be debated and developed in 1975 and implemented in 1976.

2. There should be a new act to unify the profession and provide regulatory legislation.

3. Public accountants should be licensed.

4. The designation of the members of the new body should be "Chartered Accountant".

5. The minimum educational entrance requirement for the new body should be initially a community college graduation and be raised to university graduation as soon as it is feasible.

6. The standards of final examinations of the new unified body should not preclude the transferability of graduates to other provincial associations.

7. The new body may have to provide for the training and examination of para-professional accountants.

8. Pool financial and personnel resources.

9. All present members of the 3 associations should automatically become full members of the proposed new body.

10. Reciprocity and meaningful liaison with provincial and national bodies of the 3 accounting bodies must be maintained after unification.

11. Acceptance by the memberships and resolution of present educational and training differences are major implementation problems.

12. If unification is not achieved, co-operation should be pursued.

The Steering Committee took the report back to their respective groups for consideration. Each group convened a committee to

review the recommendations. The next meeting of the Steering Committee agreed to an agenda. The following meeting, twice postponed, took place in December, 1976 at which the Institute presented the Selman Report -- a summary of which can be found in Table 3.5.1 -- rejecting the idea of unification but indicating that co-operation should be pursued.

The CGA Association expected to meet the Institute again in February, 1977 but on January 10, the Institute issued information on the Selman Report to its members and to the press. The CGA's expressed indignation at what they considered a breach of the agreed rules of the negotiations and an "...apparent desire to enhance the status of the Institute to the disadvantage of this Association and the Society...".[22] Negotiations were broken off.

The Institute, for its part, argues that while there was a serious attempt made to study the problem of unification, there was never a serious effort to amalgamate. The opposition of Institute Council sealed the decision and the press release was a way of making it public.

The Selman report reaches a number of interesting conclusions. In place of the unification idea that was a common thread throughout the negotiations of the Ad Hoc Committee we have introduction of "bridging", the idea of admitting CGA's and RIA's to the Institute following examinations. Also in place of the unification theme is the idea that the elimination of competition could well be contrary to the public interest and may well be

TABLE 3.5.1

Selman report calls for continued co-operation

Synopsis of Selman Report on unification of the accounting profession in British Columbia:

★

Fundamental conditions:

- Should be an overall benefit from the viewpoint of the community.
- Must be a substantial and lasting benefit to the membership.
- If both primary conditions cannot be met, then the Institute should not initiate or promote a merger.
- Certain benefits (possibly to both the public and the membership) could be obtained from closer cooperation amongst accounting bodies.

Public interest — the external condition:

- Any confusion that exists is not so great that there is significant public benefit to be obtained from its removal.
- Protection of the public, if needed, is a function of regulatory legislation and does not require merger.
- Elimination of competition could well be contrary to the public interest and may well be viewed as creating monopolistic control of the profession.
- If the Institute endorses the concept of a merger without a limitation on entry to practice of present members of the other merging groups, it is tacitly saying that there is no significant difference in standards and no lowering of the quality of service.
- Unless the concept and date of return to university education was irrevocably provided for, those who believe that a university education is a very important condition of qualifying as a chartered accountant in today's world might find it impossible to gain membership support for a return to that standard.
- Demand for highly trained accountants in industry is of a magnitude far beyond the ability of the universities to provide. The public interest would not allow the continuing organization to dramatically reduce the number of trainees, and therefore the university degree requirement might have to be given up permanently.
- Quality of training is monitored by the Institute. No such requirement is placed upon CGAs or RIAs. The requirement placed on the CA is of inestimable protection and value. Public interest would be appreciably damaged if this requirement were modified.

Self-interest — the internal condition:

- CGA and RIA degrees are held in high esteem by employers but their growth is traceable to one factor: It is easier to become a CGA or an RIA! Entry does not require university training and does not require a period of service.
- CAs know this and so does the business public.
- CAs can confidently expect to continue to obtain a satisfactory share of the field as long as they can provide the services.
- There would be no likely financial advantage in exchange for the considerable disadvantages that would accrue. CAs would have to accept a devaluation of the currency of their professional achievement.

Government action and inter-association co-operation:

- Advisable for the occupants of the field to be the first to publicly recognize the need for regulatory legislation. If it is perceived that there is no need then that perception and its reasons should be communicated.
- The desirable course would be to require all individuals to demonstrate basic skills and have a period of training before being permitted to practice.
- Recommendations should proceed jointly from the three principal accounting bodies. Some form of permanent structure should be established, its first task being to identify areas for common action.
- Give serious consideration to provision of a bridging mechanism whereby a CGA or RIA may be admitted to the Institute after service in a chartered accountant's office and completing the usual courses and examinations.

The final conclusions:

- Do not merge.
- Do seek limited licensing.
- Do seek co-operative action.
- Do consider bridging.

From: News and Views, The Institute of Chartered Accountants of British Columbia, January, 1977, no. 135.

viewed as creating monopolistic control of the profession. Anyone reading carefully the arguments advanced in previous chapters in favour of restrictive licensing of public accounting, along lines similar to that currently in existence in several Canadian provinces including Ontario can only marvel at the apparent inconsistency of the B.C. Institute's position.

Finally, a perplexing conclusion of the Selman report has to be the suggestion that:

> Any confusion that exists (as to the identity of accountants) is not so great that there is significant public benefit to be obtained from its removal.

The reader will recall that in Alberta, the President of the Institute of Chartered Accountants there argued against incorporation of the CGA's by Private Member's Bill on the grounds that proliferation of accounting groups would cause confusion to the public. In British Columbia, where CGA's rival CA's in the small practice field in terms of numbers, "...any confusion that exists is not so great..."

The article in News & Views stated that the Council of Institute has unanimously approved Selman's report.

D. CONCLUSIONS

A review of the situation in public accounting in British Columbia leads to the conclusion that this province comes closest to

exhibiting the characteristics of professional competition between two vigorous and growing associations with different orientations and educational philosophies. The competition is restricted to clients of small practitioners, since there are no "national firms" of CGA's, and appears to be most intense in smaller towns.

This conclusion would explain the professional associations' unique interest in advertising as well as some of the inconsistencies in the merger/unification discussions.

However, the competition is restricted to CA's and CGA's only in the auditing field where The Companies Act grants them virtual exclusivity. In the other areas of public accounting and taxation, where most small practitioners do the majority of their work, there are currently no restrictions and in the words of one practitioner interviewed, both CA's and CGA's may be seen as expensive alternatives to the untitled practitioner or service.

If the CA's find themselves at a competitive disadvantage vis à vis CGA's because of their university entrance requirement for students in accounts then so too are the CGA's at a disadvantage relative to those whose training may have been in the form of a single course or from CA students who moonlight to make extra money.

The fact that both organizations are growing, albeit in different segments of the market for public accounting, perhaps suggests

that this is the result of an essentially segmented demand structure for accounting services not corresponding growth in all sectors, from auditing of large companies to the preparation of financial statements for the neighbourhood service station.

CHAPTER 3.6

PUBLIC ACCOUNTING IN THE UNITED STATES: THE CASE OF CALIFORNIA AND NEW YORK STATE

A. INTRODUCTION

The regulatory environment of public accounting in the United States offers sufficient contrast to the situation prevailing in Ontario to make it useful for comparative analysis. Since regulation takes place at the state level, two states -- California and New York -- have been chosen for a more extensive analysis of patterns and practices.

In general, certification and licensing of public accountants is done by an appointed State Board. The Board sets out the detailed requirements for education, experience and conduct. Examinations for the certification of individuals seeking to practise are prepared and held under the auspices of the Board. The professional association is not directly involved in either the certification or licensing function and not all licensees are necessarily members of the association.

The designation(s) used by public accountants are not restricted by the professional associations as is the case in Canada. It is possible to have some variation in the standards required for certification among the fifty states, again, a significant departure from the uniformity within a designation found in this country.

Nonetheless, the designation certified public accountant or CPA is recognized by the Canadian Institute of Chartered Accountants and individuals holding that designation are accepted as members without re-examination following some courses in Canadian law and practice.

California and New York State have been chosen as examples because of their size, the mixed structure of their economies and the acknowledged leadership role that these states play in the field of regulatory legislation in the U.S. New York has the additional qualification of having been the state after which the Ontario definition of public accounting was modelled.

B. CALIFORNIA

The certification and licensing of public accountants in California is performed by the California State Board of Accountancy, an agency of the Department of Consumer Affairs. The Department is responsible for all professional and occupational licensing in the State.

The Board consists of nine members, four of whom are Certified Public Accountants, two of whom are public accountants (see below) and three of whom are members of the public, not licensed or registered by the Board. Each of the non-public members of the Board must be in active practice and have been so for a period of

at least five years. Board members are appointed for terms of four years.

The California Accountancy Act (Business and Professions Code, Div. 3, ch. 1) establishes the Board and grants its powers. The Board as a whole has the power to:

> Section 5010. ...adopt, repeal, or amend such regulations as may be reasonably necessary and expedient for the orderly conduct of its affairs...
>
> Section 5018. The board may be regulation, prescribe, amend or repeal rules of professional conduct appropriate to the establishment and maintenance of a high standard of integrity and dignity in the profession.

However, the major functions of the Board are carried out through a series of committees established by the Board and empowered to deal with discipline, qualifications and continuing education. There are two administrative committees, one of which is composed of public accountants, the other of Certified Public Accountants, whose function is to deal with complaints and conduct investigations on matters of conduct or violations of the Act. Appeal is to the Board.

The Certified Public Accountant Qualifications Committee consists of CPA's who may or may not be members of the Board with the power:

> Section 5023: (a) To examine all applicants for the certificate of Certified Public Accountant.
>
> (b) To recommend to the Board applicants for the certificate of CPA who fulfill the requirements of (the Act).

As of year end, 1974, the California legislature made continuing education mandatory as a prerequisite to the renewal of public accountancy licences. The Board is empowered to set standards of

continuing education and to make regulations defining the basic requirements, delineate the qualifying programs and make rules for control and reporting. Licensees not in public practice are exempted. The committee established to monitor continuing education is also responsible for administering the program.

At the present time, there are two types of public accountants in public practice in the State; those that are certified and those that are not. In 1977 there were 20,251 CPA's and 6,916 PA's licensed. The Act defines the two groups as follows:

> Section 5033. "Certified public accountant" means any person who has received from the Board a certificate of certified public accountant and who holds a valid permit to practise under the provisions of (the Act).
>
> Section 5034. "Public accountant" means any person who has registered with the board as a public accountant and who holds a valid permit for the practise of public accountancy.

For the purposes of the Act a "person" includes individuals, partnerships, firms, associations or corporations.

In fact, the category of "public accountant" is effectively closed and consists of persons who were in practice at the time the Act came into force. The Act makes no mention of a route into the "public accountant" category, only out since "public accountants" may take the CPA examination.

However, the Act is very careful to assure that both CPA's and PA's are given equal rights and standing in the public accounting field by mentioning both in each instance and by stating that in the area

of government work:

> <u>Section 5036.</u> Whenever any statute requires that any reports, financial statements and other documents for any department, division, board, commission or agency of this State be prepared by CPA's, such requirement shall be construed to mean public accountants or CPA's.

The area of practice restricted to licensees is set out in Article 3 of the Act. Only holders of valid permits (note: not certificates) to practise public accountancy are included. The Act defines "public accountancy" as follows:

> <u>Section 5051.</u> ...a person shall be deemed to be engaged in the practice of public accountancy within the meaning and intent of this (Act):
>
> (a) Who holds himself or herself out the public in any manner as one skilled in the knowledge, science and practice of accounting, and as qualified and ready to render professional service therein as a public accountant for compensation; or
>
> (b) Who maintains an office for the transaction of business as a public accountant; or
>
> (c) Who offers to prospective clients to perform for compensation, or who does perform on behalf of clients for compensation, professional services that involve or require an audit, examination, verification, investigation, certification, presentation or review, of financial transactions and accounting records; or
>
> (d) Who prepares or certifies for clients reports on audits or examinations of books or records of account, balance sheets and other financial, accounting and related schedules, exhibits, statements, or reports which are to be used for publication or for the purpose of obtaining credit or for filing with a court of law or with any government agency, or for any other purpose; or
>
> (e) Who, in general or as an incident to such work, renders professional services to clients for compensation in any or all matters relating to accounting procedure and to the recording, presentation, or certification of financial information or data.

The definition appears to be both all encompassing and relatively explicit even including under (c) "consulting" work in areas of financial statement preparation. The next section of the Act describes the areas not covered.

> <u>Section 5052</u>. Nothing in this (Act) shall apply to any person who as an employee, independent contractor or otherwise, contracts with one or more persons, organizations or entities, for the purpose of keeping books, making trial balances, statements, making audits or preparing reports, all as a part of bookkeeping operations, provided that such trial balances, statements or reports are not issued over the name of such person as having been prepared or examined by a certified public accountant or public accountant.

The regulations state that "making audits" as it applies to the section above refers to internal audits only.

The Act also makes exceptions for public accountants who met the requirements of previous statutes and are registered, employees of CPA's or PA's who work under supervision, lawyers, and corporations in existence at the time the Act became effective.

Article 4 of the Act deals with applications, registrations and permits. Permits to practise public accountancy (licences) can be issued only to CPA's and to persons and partnerships registered with the board. Permits are valid for two years and must be renewed by the permit holder. Partnerships must be registered separately and the board sets separate standards for the composition of CPA and PA partnerships.

The granting of certificates, in effect the only current access to the public accountancy field in California, is covered in Article 5. The requirements are lengthy and complex. Only a synopsis is provided here and the interested reader should seek out the Act and Regulations as listed in the Bibliography.

To obtain a certificate and become a CPA, an individual must first be granted admission to the examination. Admission is granted to an applicant who:

(a) is of good moral character;

(b) has completed 4 years of high school or equivalent (including 3 years of English and 2 years of Math);

(c) has one of:

  (i) a baccalaureate degree with a major in accounting or related subjects to a minimum of 45 semester hours of instruction in such subjects;

  (ii) an associate in arts degree from a junior college or completed a two year program and has studied accounting, commercial law, economics, finance and related business administration subjects for a period of at least 4 years;

  (iii) equivalent qualifications to those above and pass an examination of qualification;

  (iv) registration as a public accountant.

The applicant must be over the age of eighteen and pass the CPA examinations in:

(a) theory of accounts;

(b) accounting practice;

(c) auditing;

(d) commercial law as affecting accountancy;

(e) related subjects.

The examinations are held at least semi-annually, and the board "...may contract with any organization, governmental or private for examination or services." (Section 5089) Individuals taking the examination do not need to be residents of the State. Conditional credit is given for subjects passed.

Before the certificate is granted and a permit to practise can be secured, the experience requirements set out in sections 5083 and 5084 must be met. Three options are available to the applicant and a one-year experience credit is granted to applicants who have an undergraduate degree with a major in accounting.

Option A - 3 years experience in public accounting of which two must be with a CPA or PA office or firm.

Option B - 3 1/2 years experience in public accounting of which one must be with a CPA or PA.

Option C - 4 years experience in public accounting if none was with a licensed CPA or PA.

The board has prescribed rules establishing the character and variety of experience necessary to fulfill the experience requirements set forth. Note that unlike the situation found among Chartered Accountants in this country, firms or offices need <u>not</u> be approved for training and under Option C all of the experience may be gained outside of a public accounting firm.

After successful completion of all aspects of the examination, a course in professional ethics and the necessary experience requirements, an individual would normally receive the CPA certificate. It is important to remember that, unlike the situation in Canada where

CA students cannot sit for the UFE without having completed their experience requirements, anyone meeting the applicant standards can attempt the CPA examinations. This is undoubtedly a factor in explaining the low overall success rate of the exam, as shown in the Table below.

TABLE 3.6.1

COMPARATIVE SUCCESS FACTORS IN CALIFORNIA CPA EXAMINATIONS

TIME OF EXAM	% PASSED & COMPLETED EXAM	% PASSED PART OF EXAM	% FAILED
NOV.1973	20.7%	27.1%	52.3%
MAY 1974	20.5%	26.0%	53.5%
NOV.1974	20.9%	25.0%	54.1%
MAY 1975	19.2%	24.8%	56.0%
NOV.1975	20.3%	23.7%	56.0%
MAY 1976	18.2%	23.5%	58.3%
NOV.1976	17.7%	24.0%	58.3%
MAY 1977	17.3%	23.1%	59.6%

Source: California State Board of Accountancy

Note: Numbers may not add to 100% due to rounding.

The success rate among Public Accountants writing the CPA exams is even lower. In the most recent results available (May 1977) 17 wrote the exams, none passed unconditionally, 4 received conditional passes and 13 failed.

As mentioned above, continuing education has been a requirement for re-licensing since 1974. Both CPA's and PA's are required to submit proof to the Board that they have undertaken acceptable continuing education. The Continuing Education Committee has developed extensive rules covering the policies and interpretations. Generally, every licensee is subject to the continuing education requirements if he

performs for any compensation whatever any service normally performed in public accounting including the preparation of tax returns or other services which may be performed by persons who are not licensed. The types of education approved for credit are quite broad and include seminars, meetings of professional accounting associations, teaching and publication of articles. For further information the reader is referred to the materials listed in the attached Bibliography.

C. NEW YORK

Public accounting regulation in New York is similar in large measure to the practice described for California. A state board of accountancy is appointed by the Board of Regents and operates within the state education department. The Board consists of twenty-one individuals, sixteen of whom are CPA's, four of whom are public accountants and one other. On January 1, 1978, two lay members were added to the Board. The Board's powers cover certification, licensing and professional conduct.

There are two types of licensees as in California: Certified Public Accountants and Public Accountants, the latter a group of "grandfathers" who were in practice before 1959. Licences are issued for a two-year period. For the biennial period of 1976 to 1978 there were 23,032 CPA's and 4,804 PA's registered to practise in New York.

Practice and use of the title CPA and PA are restricted to licencees. The defined area of practice is set out in Article 149, Section 7401 of the New York statutes as follows:

> <u>Section 7401</u>. The practice of the profession of public accountancy is defined as holding one's self out to the public, in consideration of compensation received or to be received, offering to perform or performing for other persons, services which involve signing, delivering or issuing or causing to be signed, delivered or issued any financial, accounting or related statement or any opinion or, report on, or certificate to such statement if, by reason of the signature, or the stationery or wording employed or otherwise, it is indicated or implied that the practitioner has acted or is acting, in relation to said financial, accounting or related statement, or reporting as an independent accountant or auditor or as an individual having or purporting to have expert knowledge in accounting or auditing.

The reader familiar with the definition of public accounting in Ontario will readily perceive the similarities between the two definitions. In scope and wording both definitions cover similar ground and focus on the key area of adding credibility to financial information by association and for the use of third parties.

Section 7407 lists a number of exemptions to the licensing requirements. Unlike the exemptions in California a defined area of public unlicensed practice is <u>not</u> specified. Rather individuals performing functions in some way that does not imply that they are themselves offering services to the public. For example, exemptions cover:

(a) an officer of a corporation who in his capacity as such signs, delivers or issues financial statements, etc.;

(b) an attorney at law acting in a manner incidental to the practice of law;

(c) an employee of a licensed CPA or PA;

(d) a government official acting in his capacity for the state;

(e) a public accountancy corporation, in existence before 1959, in which unlicensed individuals do public accountancy provided that it is under the supervision of a CPA or PA.

In order to qualify for a licence as a certified public accountant, an applicant must fulfill requirements in the following categories:

(1) Education -- a Bachelor's degree or higher based on a program in accountancy. In other words, education specifically in the accounting field;

(2) Experience -- meet the Board's regulations. Usually three years, of which one year may be waived;

(3) Examination -- pass the CPA examination;

(4) Age -- at least twenty-one;

(5) Citizenship -- no requirement.

The statute provides for an alternative path to the CPA examination. Namely, fifteen years experience in the practice of public accountancy may be accepted in lieu of the education and experience requirements stated above.

The state board is considering extending the education requirements for licensing. In hearings held in October of 1977, the Board proposed an amendment that would make a five-year post-baccalaureate degree and a graduate curriculum in accounting mandatory after September, 1982. The current requirement which became effective in 1938 requires an individual to register in an accounting program that offers a major in the field with a total of 120 semester hours. The new proposal, which was unanimously approved by the Board and is

essentially the same as one proposed by the Board on standards of the A.I.C.P.A., would raise the course qualifications to the level of a graduate degree program of at least 150 semester hours. Details of the proposal are given in a memo cited in the Bibliography.

The state board provided information on the most recent CPA examinations, including breakdowns on those who qualified for certification. Specific information on applicants with graduate degrees and females was also provided. The Table below (Table 3.6.2) provides a summary. The greatest number (modal value) of applicants who qualified took the examinations three times and required two- to two and one-half years to complete the examination process. The points raised about the success factors in California seem to apply to New York as well although it should be recalled that all those taking the examination had completed programs in accounting before sitting for the examination.

TABLE 3.6.2

C.P.A. EXAMINATION RESULTS
IN NEW YORK - MAY 1977
EXAMINATION

SUBJECT	% PASSING
THEORY	24% (28.9%)
BUSINESS LAW	24% (28.0%)
AUDITING	32% (27.0%)
ACCOUNTING PROBLEMS	27% (31.0%)

Source: New York State Board of Accountancy

Note: Figures in brackets are the national averages.

As mentioned above, New York has a class of licensees called "Public Accountants" that is essentially closed. Section 7405 of the statute sets out the requirements for licensing as a public accountant. Among other requirements an individual must have been in practice as a sole proprietor, partner or employee of a public accountant or government department or agency (doing public accounting work) for a total of six out of the ten years preceding the year 1959. In addition, the individual must be planning to engage in public accounting on a full time basis. The number of individuals meeting these requirements at this point in time is undoubtedly small. Hence, the "Public Accountant" category of licensees is essentially closed.

There are two other differences between California and New York worth noting here. First, it appears that, unlike California, New York does not distinguish directly between the attainment of the CPA certificate and the issuance of a permit to practise. If the New York statute is taken literally, an individual must meet the "requirements for a licence as a certified public accountant." In practise, certification and licensing take place as a single step. What this means is that CPA's who choose not to practise either initially or for some period during their career, say to pursue employment in management, could readily return to public practice at a later date. Except for a re-application for a licence, no additional requirement would seem to be imposed.

The second point of note concerns continuing education. New York

does not currently require evidence of approved continuing education as a prerequisite for licence renewal. Legislative changes making continuing education mandatory are being considered but no action has yet been taken. The absence of continuing education or re-certification requirements affects the public interest in cases such as that mentioned above in which CPA's return to public accounting practice after prolonged absences.

This concludes the review of regulatory legislation and practice in California and New York. The review is of necessity short, focusing on the law and regulations in each jurisdiction. A more complete review would consider the role that the professional bodies, primarily the American Institute of Certified Public Accountants, play in the regulation of public accounting at the state level either directly or indirectly. Likewise, additional analysis would focus on areas of conflict, if any, created by the existing regulatory scheme. Such an analysis is beyond the scope of this paper.

CHAPTER 3.7

CONCLUSIONS

As a technique, comparative analysis has its limitations. It is essentially descriptive in nature. It is open to the challenge that major situational differences between jurisdictions invalidate the conclusions. This is particularly true in "soft" areas like professional regulation where institutions, history, and even cultural factors have played a significant role in shaping the regulatory environment observed. An added dimension in accounting might well be the size and composition of the economy as it influences the demand for specialized services and hence the type of firm and practice established to meet those demands.

Notwithstanding these caveats, several limited conclusions can be drawn from the facts. First, it is clear that a number of different regulatory schemes can be made to work and work effectively in the accounting field. Stated differently, there was no evidence brought to the attention of the author that suggested that those jurisdictions without licensing or with limited licensing were significantly worse off than those with licensing. In both British Columbia and Alberta there was no evidence to suggest that the public - whether client or investor - was poorly served by the absence of public accounting legislation, particularly in those aspects of public practice that have typically been regulated. This is not to say that abuses do not exist; only that they were not widespread enough to create a problem that the professional associations and the government would

wish to eliminate. Possible reasons for such an absence are explained at the end of this submission.

The second conclusion that can be drawn is that merger of the professional accounting associations, whether voluntary or under the aegis of a government, has not been particularly successful as a means of resolving intra-professional disputes. This study chronicles two such attempts - one in British Columbia and one in Quebec - and the review of regulation in Ontario describes a third. In none of these cases was merger the result. Although the discussions appear to have been undertaken with serious intentions, the inevitable result seemed to be that the professional groups discovered "irreconcilable differences" that prevented mergers from going forward. Thus it would seem that a recommendation favouring a merger would merely be a way of postponing a re-appearance of the original dispute while the protagonists talk. This is not to say that mergers or similar accommodations never work. Although the situation was not specifically reviewed, it appears that the professional accounting associations in Europe were able to reach just such accommodations following the establishment of the common market, in spite of substantial differences in a number of areas.

Finally, one might conclude from the available evidence that there exists within each professional association a national strategy vis à vis regulatory legislation. The similarities in proposed legislation, in the positions advocated in briefs, in the stance taken in merger discussions and in the kinds of transfer provisions

considered would lead to the conclusion that a common thread runs through each one. The degree of success that has been achieved with the strategy depends largely, it would appear, on the relative strength and position of the accounting bodies in the province and the receptivity of the government in power. Thus in British Columbia it would be highly unlikely that regulatory legislation favourable to the CA's and not to the CGA's could be passed since the latter are both numerous in the public accounting field and enjoy considerable political support. In Alberta, by contrast, no regulation has been introduced because the government of that province is unreceptive to such legislation in the absence of a clearly demonstrated problem. This is true in spite of the strong position of CA's in that province.

Final decisions on the form that regulatory legislation in Ontario should take, cannot and, indeed, should not be made on the basis of comparative evidence alone. However, this review of other jurisdictions will be of value in suggesting the range of regulatory (and non-regulatory) options which various jurisdictions have considered appropriate in the field of public accounting.

FOOTNOTES TO CHAPTER 3

1. For more detail on the objects, organization, role and membership requirements of these associations the reader should refer to Appendix A of the Research Directorate's Staff Study, "History and Organization of the Accounting Profession in Ontario."

2. Municipal Commissions Act, S.Q., 1964, c.170, s.78 and 79.

3. Ibid.

4. Co-operative Agricultural Associations Act, S.Q., 1964, c.124, s.19, 22 and 27.
   Co-operative Associations Act, S.Q., 1964, c.292, s.86-92 and 116.

5. Savings and Credit Unions Act, S.Q., 1964, c.293, s.43, 81, 87, 92 and 108.

6. B.G. Levine, C.A.,"The Profession in Quebec - A New Order", CA magazine, November 1976, pp. 36-38.

7. National Assembly of Quebec, Bill 250, Professional Code, p. la.

8. Ibid., Section 26, p.9.

9. Levine, op. cit., p. 37.

10. The Act changes the name of the body from The Institute of Chartered Accountants to The Order of Chartered Accountants.

11. These quotes are taken from an unofficial translation of the Supplement to the Report justifying the withdrawal of the Professional Corporation of Industrial Accountants of Quebec from the tripartite Committee on an eventual merger of the professional bodies of accountants.
    p. 5, mimeograph dated September 19, 1975.

12. Professional Corporation of CGA's, "Comments and reactions of the representatives of the Professional Corporation of CGA's relative to the April 1975 report of the Chartered Accountants of Quebec." mimeograph, dated January 14, 1976.

13. B.G. Levine , C.A., op. cit., p. 38.

14. Idem.

15. It appears that the Saskatchewan Legislature turned down petitions by the Certified General Accountants Association and the Institute of Accredited Public Accountants for Private Members Bills Respecting Incorporation and submitted in the Spring of 1975 on the basis that Mr. Lowrey's investigations would provide a framework within which to consider the future structure of the accounting profession in Saskatchewan.

FOOTNOTES (cont'd)

16. I.C.A.A., submission to the special Legislative Committee on Professions and Occupations, (Chichak Committee) page 3.

17. I.C.A.A., *op. cit.*, p. 3.

18. I.C.A.A., *op. cit.*, p. 14.

19. Government of Alberta, Special Committee of the Legislative Assembly of Alberta on Professions and Occupations, *Report*, December, 1973, p. 29.

20. For a complete list of practising CA offices in B.C., see the Bibliography, item 2 under British Columbia.

21. The Society of Management (Industrial) Accountants were not interviewed because of time constraints. However, based on the primary evidence it seems that their views would not be dissimilar.

22. C.G.A.A.B.C. Letter to the President of the I.C.A.B.C. reproduced in Rationalization.

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CHAPTER 4

AN ARGUMENT FOR DE-LICENSING PUBLIC ACCOUNTING IN ONTARIO

Fred Lazar and J. Marc Sievers

In drawing out the policy implications of our findings, the three authors of this report are not unanimous. The two authors of the present chapter believe that a strong case can be made for de-licensing public accounting in Ontario. Our colleague, Dan Thornton, favours a retention of licensure on a somewhat more limited basis than at present, and his position will be summarized, together with ours, in the next chapter. In this chapter we wish to elaborate the case for de-licensure.

Government regulation of an industry can be justified in any of the following three cases: (1) the existence of a natural monopoly; (2) the exploitation of a common resource pool; and (3) the need for a minimum quality and/or safety standard. For the accounting industry, only case three can be used to support continued government regulation. Consequently, it is necessary to consider the question of standards in order to determine whether or not regulation is necessary, and if regulation is required, the desired form that it should take. For the accounting industry, a discussion on standards focuses on the ability of an individual performing public accounting and the quality of the services that are being provided.

We emphasized in Chapter 2 that it is extremely difficult, if not impossible, to establish an objective measure for quality of

service in the accounting industry. Nevertheless, let us set aside this problem and assume instead that quality can be measured; that information on quality differentials across firms and across accounting designations is readily available to all users of accounting services and that the information is entirely accurate. With the assumptions of perfect information and competitive markets on the demand side of the accounting industry, we can demonstrate theoretically that the users of accounting services will select the optimal quantity and quality levels of the various services consistent with their profit-maximizing objectives. The resulting demands will also be optimal from an aggregate economic efficiency point of view. Some may counter that the solutions will not be optimal, particularly the demands for public accounting services. In light of our previous discussion in Chapter 2, one can develop the argument that there may not be a strong incentive on the part of a business firm that needs to purchase public accounting services to consider the quality of the services as an important input. Indeed, we have hinted that where the need for public accounting services is directly or indirectly imposed upon a business firm, it is possible that the business firm might rationally choose to minimize both price and quality, and as a result, demand a suboptimal quality level of public accounting services.[1]

But we have also suggested, in Chapters 1 and 2, that there may be other factors influencing a firm to purchase public accounting

services and, that in this decision framework, quality will be treated as a key input. Furthermore, considering the market strength of financial institutions, it is quite likely that there will be sufficient pressures placed upon business firms to consider quality of service as an important factor. Consequently, there are good reasons to assume that in a system with perfect information and competitive markets, that the optimal solutions will be attained and quality of service will be considered as a key variable. Hence, in light of this theoretical conclusion, it appears that if a need for regulating the industry arises because a suboptimal level of quality is being purchased, that one or two critical assumptions are not being met. Either perfect information is not available to potential users or the markets are not functioning competitively.

The market failure that is presumed to occur in the accounting industry (and thus serve as a basis for regulation) is a lack of adequate information on the quality of accounting services and manpower in the industry. Given the general unavailability of information on all aspects of accounting services and at the same time the inability to measure quality, the clients on the demand side of the accounting industry are operating with a high degree of uncertainty. These firms can use various signals as proxies for quality. But in the process they are likely to develop rather serious misperceptions of the quality dimensions of the services that they are purchasing. Professor Spence of Harvard University has demonstrated that when firms on the demand side of a market possess imperfect and generally inaccurate information

about quality standards, it is possible, under certain conditions, that suboptimal quantities of quality are being purchased and that, as a result, the economic system will not function in a pareto optimal manner.[2] The imperfect information on quality and the possible suboptimal performance of the economy are the arguments generally put forth justifying regulation of the accounting industry. As a result there may appear to be some merit to the argument that, because of the ignorance of consumers of accounting services, at least with regards to the quality of these services, it is possible that suboptimal economic results may occur. At the same time however, the argument that consumers of accounting services will always have an incentive to opt for the lowest price and minimize quality is an irrelevant argument for, as we have pointed out above, in a regime of perfect information, firms will select, given the various constraints on their operations, the optimal combinations of price and quality of services. Whatever the results are of these decisions, they are likely to be optimal from an aggregate economic perspective even if some firms, on the demand side, select to trade-off a lower quality service for a lower price. The optimal combination of price and quality in the presence of perfect information can be determined only by the firms on the demand side and the constraints of competitive market forces on their behaviour. Accountants or firms on the supply side cannot determine the optimal combinations of prices and quality.

Now that there appears to be a reasonable economic argument

supporting regulation of the accounting industry, at least in the form of establishing or guaranteeing minimum quality standards, there are three questions that we must consider: (1) How inaccurate are the perceptions of the clients on the demand side? (2) How important in terms of overall economic performance are these misperceptions? (3) Can any regulatory regime ensure that the optimal levels of quality will in fact be purchased in the market place? We will deal with the third question first. Members of the Institute of Chartered Accountants of Ontario have argued that officials of the Institute are best able to determine the nature of the training program that prospective public accountants must undertake and, at the same time, establish the minimum quality standards that prospective accountants must attain, in the form of successfully completing examinations testing the various principles of public accounting, before they can be designated as chartered accountants and, in turn, qualify to become public accountants in this province. While it is undoubtedly correct that the Institute of Chartered Accountants of Ontario is in the best position to determine the principles that should be adopted in audits and non-audit reviews, the course of research into public accounting questions and the course of study for prospective CA's, there is no guarantee whatsoever that the standards established by the Institute for individuals to be designated as CA's are at an appropriate level to ensure that the optimal quality levels of public accounting services will be available and purchased in the market place.

The Institute has every right to set its own standards and perhaps the standards of the training program of the Institute of Chartered Accountants are superior to those of other accounting programs. Nevertheless, whatever the standards are that are set by the ICAO, there is no assurance that there will be a strong positive correlation between the quality of services actually provided and these standards, and in addition, even if there is a strong positive correlation, there will be no guarantee that the minimal quality standards established by the ICAO will be economically optimal. With regards to the former point, it is conceivable that students qualifying for the CA designation are inadequately trained or prepared to engage in public accounting. The passing of exams does not ensure an understanding of the various principles involved in public accounting, nor does this ensure a high level ability to provide public accounting services. As we discovered from our surveys of public accounting firms, and as we reported in Chapter 2, students trained in smaller firms spend a much smaller proportion of their time involved in public accounting activities than students in the larger firms. Moreover, there is more likely to be a formal training or education program in the larger firms. Hence, in that chapter, we questioned whether the training of students in smaller public accounting firms was adequate to enable them to qualify for the CA designation and, if they did succeed in passing the examination requirements, whether in fact they would be adequately qualified to practise public accounting.

Furthermore, the passing of a set of exams at one point in time with no further retesting at future points in time seems to cast into doubt the contention of the ICAO that they do in fact guarantee a minimum quality and/or ability standard. It is conceivable that at some time in the past the individuals that received the CA designation were capable of performing public accounting at a rather high quality, given the standards of those days. But, in light of the fact that there has been continual development of new auditing and accounting principles and that, in the case of accountants working in smaller public accounting firms, many have been unable to keep abreast of the various innovations, consequently, it is likely that there are several public accountants that are no longer capable of providing high levels of public accounting services. In effect, in the absence of continual involvement in public accounting and/or learning of new principles, it is possible that there may be a rather high rate of obsolescence of skills learned as a student in the CA program. Thus, over time an individual may become less and less able to meet the then prevailing quality standards for new CA designates and, supposedly, the profession in general.

Moreover, even if we assume that there is no depreciation of the skills of public accountants, there is no guarantee that all public accountants will perform their services for a client at the highest standards of which they are capable. For example, it is quite possible that, at the present time, some accountants,

while performing an audit, do not adhere to all the guidelines set forth by the Institute. There is even greater scope to diverge from the principles established by the Institute when accountants perform non-audit reviews or non-reviews. And in these latter two cases, the risks associated with doing a sloppy job are much less severe and constraining than they are in the case of performing an audit. The risky nature of audits and the possibility of malpractice suits against public accountants may serve as a strong enough incentive to ensure a high standard of quality in performing the audit function. But the same degrees of risk do not arise in the performance of other public accounting functions.

There are also rather dramatic differences in the standards that have been established for performing audits, non-audit reviews and non-audit non-reviews. Hence, one cannot plausibly argue that there is a uniform quality standard for the provision of public accounting services. Even if all public accountants were equally qualified and competent, the fact that differences exist among the accounting principles underlying the three types of public accounting activities ensures a non-uniformity in quality standards. Indeed, as some U.S. studies[3] have demonstrated, there is quite a diversity among public accountants in the U.S. in the various principles that they adopt in performing a non-audit review. This is likely to be the case in Ontario as well and thus even though the Institute may establish the standards for receiving a CA designation and set

out acceptable principles to follow when undertaking non-audit reviews or non-reviews, there is no guarantee that the quality of the service provided by different public accountants will be the same. At the present time there is no quantitative measure for quality of service and so there is no method for determining whether other public accounting services are provided at or above the minimum quality standards suggested by the ICAO. Thus, while we may tentatively conclude that the ICAO is in the best position to determine minimum desirable (from the point of view of the accounting profession) quality standards, it is unable to ensure that these minimum quality standards are in fact being provided by the members in the industry.

Even if the problems discussed above did not exist it might still be possible that the minimum quality standards established by the Institute are suboptimal. Clients demanding public accounting services operate under various constraints and are likely to differ with respect to their preferences over quality and price of services purchased. Given the heterogeneous nature of the firms on the demand side of the accounting industry, it seems reasonable to argue that it is impossible for the Institute to determine what the minimum quality standard demanded in a competitive market with perfect information will be. In order to establish the appropriate or optimal quality standard it would be necessary to have a reasonably accurate estimate of the market determined minimum quality standard. The establishment by the Institute of a standard marginally different from what would be

selected in the ideal market environment will, under the conditions postulated by Spence, produce an improvement in aggregate social welfare (keep in mind, however, the implications of the theory of second best as discussed in footnote 2). However, if the minimum quality standards selected diverge dramatically from the level that would be selected in the ideal market environment then it is quite possible that the performance of the economy will not be improved and conceivably under certain circumstances the performance of the economy might be even worse. Too high a standard may be more deleterious to overall economic performance than the lack of any standard whatsoever. For example, the establishment of too high a standard, and at the same time, concomitantly higher prices for public accounting services, may result in many prospective clients being priced out of the market. This might in turn exclude these various business firms from being able to qualify for loans and thus prevent many potentially successful firms from being established or expanding. Or the financial institutions, realizing that some of the prospective borrowers can no longer afford to hire a public accountant to review their financial records, might decide in turn to discard this requirement for qualifying for a loan. Under these circumstances, the financial institutions could undertake their own search or review activities of the financial records of prospective borrowers, or they could make loan decisions with more imperfect information and thus higher levels of uncertainty. In this case then, there may be a more inefficient functioning of the market place if the higher levels of uncertainty and risk

produce excessively high risk premiums in lending rates or in the creation of greater barriers for small companies to obtain funds from financial institutions. In conclusion to the third question posed above, it appears that both theoretically and practically it is nearly impossible to establish what the optimal minimum quality standard should be; and, secondly, that it is extremely difficult to ensure that the minimum quality standard, whatever it may be, is adhered to in the provision of public accounting services.

Let us now assume that the above problems did not exist and that the Institute could indeed set the appropriate quality standards and guarantee that the effective levels of quality of service provided did, in fact, exceed the minimum levels. This brings us then to the first of the questions raised above; namely, in the absence of regulation, will the misperceptions of firms operating on the demand side of the market be grossly inaccurate. In other words, how ignorant are the consumers of accounting services? As we have pointed out in Chapters 1 and 2, the accounting industry appears to be segmented. In the segment in which large business clients operate on the demand side it is highly unlikely that, in the absence of regulations, these clients would grossly mis-estimate the quality of the services that they are purchasing. Indeed, given their associating quality with size of accounting firm, designation of accountants, and reputation of the firm, it is unlikely that these large clients would associate high levels of quality with low price accounting firms consisting

of individuals with designations other than the CA.

The large clients are restricted, either by necessity or choice, to dealing with the big eight national public accounting firms in Canada. These clients have been able to switch from the big eight to smaller and "lower-priced" public accounting firms. Despite the arguments that have been put forth that imply that large firms have an incentive to trade off price against quality, this type of decision does not appear to have been made in the past and there is no reason why this type of decision will be made in the future. Hence, we conclude that the relationships between large business clients and large public accounting firms will remain, to a large extent, unaltered under a system with no regulation.

Thus if perceptions of quality are to be grossly in error, this will most likely occur in the segment of the accounting industry in which small business firms deal with small public accounting firms. We exclude that segment in which small business clients deal with large public accounting firms since it appears in this case, given the common notion that large public accounting firms are higher priced firms, that the business client has selected a large firm because of the presumed positive correlation between size and quality and the need or desire of the business client to have a higher-quality service provided. In the segment then that remains, we must ask the question why the small business clients demand public accounting services? As we pointed out in

Chapter 2 the primary reason for small business clients to require such services is to meet the demands of a loan officer in a financial institution, most likely a chartered bank. Consequently, it is more important to know the degree of ignorance of loan officers at the lending institutions. While it is likely that small business firms, if they have the option in a non-regulatory regime, to hire an accountant at a lower price and commensurately lower level of quality, will make this explicit choice, this does not imply that the resulting review produced by a non-CA public accountant will be accepted by the loan officer at a lending institution or will be considered in the same light as a review prepared by a CA public accountant. Indeed, in view of the remarks made to us in our interviews with officials of the chartered banks, particularly the remarks dealing with their associating quality with the accounting designation and size of public accounting firm, it is probable that reviews prepared by different sized firms and accountants with different designations will be treated in different manners by lending institutions. Thus, while it is possible that the perceptions of small business clients of quality of service may be highly inaccurate, it is less likely that the same is true for third party users such as loan officers; it is quite possible that in many cases the loan officers will continue to suggest to small business companies what group of accountants they should approach in order to have a review performed. It is conceivable, indeed, we argue highly likely, that even in a regime with no regulation the bulk of public accounting service will continue to be provided by pre-de-regulation public accountants and new

CA graduates. The main impact that will be made by "new" non-CA public accountants will likely occur in smaller urban areas in which CA's are working at or beyond capacity or in cases where small business companies could not previously afford the services of a public accountant. In the latter case, the small business company might be better off having an accountant qua accountant review and/or prepare a statement in support of a loan request than to not have any accountant perform this task. Furthermore, if any market penetration is to be made, it will be made more in other public accounting such as non-audit reviews etc., than in the area of auditing. We base this argument on the higher risks associated with audits and the likely higher premiums that will be established for liability insurance for non-CA public accountants. In other words, with efficiently functioning insurance markets, liability insurance premiums will be inversely related to the perceived quality of the accountant and in turn, quality is likely to be positively related to the number of years of experience, the length of training and education required to receive an accounting designation.

All in all, on the basis of the information that we have obtained from the various surveys and interviews, we have to conclude that, even under the present circumstances where information on the qualifications of accountants is generally lacking, the degree of ignorance on the demand side of the accounting industry is not likely to be anywhere near as great as perceived to be by the members of the accounting profession. Furthermore, if <u>informative</u>

advertising is permitted,[4] that is, advertising that enables the various bodies granting accounting designations to inform the public of the type and quality of program that the graduate must successfully complete in order to receive his or her designation, and at the same time if public accounting firms are permitted to list the qualifications and experience of their personnel, then the general degree of ignorance or, more accurately, the imperfections in the information available in the market place will decline, and the perceptions of quality will be more consistent with the notions of quality perceived by the members of the ICAO.

We should emphasize once more, as we did in Chapter 2, that it is extremely difficult if not impossible to accurately measure quality in the accounting industry, and thus, when the ICAO discusses misperceptions of quality standards, they are using their notions of quality as a basis for comparison. Hence, with informative advertising permitted the price-quality decisions made by firms operating on the demand side of the accounting industry are more likely to generate the optimal combinations than will a regulatory regime in which the ICAO, or other public accounting body, establishes a minimum quality standard for the entire profession. If, in a situation in which regulation does not exist and more useful information is made publicly available, business firms decide to hire a lower priced accountant and make a knowing decision to trade-off quality for price, the business firm cannot be accused of selecting a suboptimal level of quality. As we discussed at the outset of this chapter, the argument that is

generally made that business firms will eagerly trade off quality for price is irrelevant if this selection is consistent with their optimizing a particular rational objective function subject to the various constraints on the behaviour of the company. With more perfect and/or complete information, the optimal quality standard can or should be decided by the business company and not by a regulatory body of the public accounting profession.

Addressing ourselves now to the second question, namely, will it make any difference in terms of overall economic performance if perceptions of quality are grossly inaccurate, we must consider the importance of the quality of public accounting services in influencing overall economic performance. We have dealt with this issue to some extent in Chapter 2 and we arrived at two basic conclusions: (1) quality differences in the provision of public accounting services might have a distributional impact and (2) quality differences might have an impact on the functioning of the capital markets and hence the growth rate of the economy. Indeed, it has been argued by many, that the main impact of public accounting is on the operation of the capital markets. This then raises the question of how important are audited or reviewed statements for the functioning of the capital markets?

Public accounting makes the information available to the market-place more credible. Audits or non-audit reviews lend credence

to the fact that the activities underlying the financial statements did take place or at least took place along the lines reported by the company. However, public accounting deals only with past information. Public accounting is not intended to deal with future information. Audits or non-audit reviews do not provide any information as to the future profitability of a company; they do not provide any information on the potential recoverability of loans outstanding or trade credit outstanding. Thus, it is conceivable at a given point in time when an audit or non-audit review has been performed, that while the company's records seem intact and accurate and the company appears to be viable, it will prove to be insolvent as time passes.[5]

In light of the current recession in Canada, it is possible that there are many companies for which a significant proportion of their trade receivables will never be recovered, the proportion being significantly higher than the appropriations for expected losses. And here again, audits or reviews cannot or indeed are not intended to discover and report this information. Obviously, only with the passage of time will such information become available.

Public accounting as well, cannot and is not intended to predict future events such as the course of general economic activity, international economic developments and domestic and international political developments. These various factors will have rather

dramatic impacts on the profitability of all companies and may be given a much greater weight in the assessment by the capital markets of the profitability and strengths of the various business establishments in the country. Indeed, under the present economic circumstances in Canada, it may be much more important for a loan officer to know or to have a rough idea of what future general economic conditions will be and, more specifically, how these conditions will affect the industry in which a given company requesting a loan is operating. Knowledge of past information on the company, while it may be important to some degree in assessing how the particular company may perform relative to its industry in general, cannot be used to determine the ability of the company to meet its interest rate obligations in the future and its ability to repay the loan over the scheduled period. Thus, given the relative importance of future events for the functioning of the capital markets, it is quite possible that even in a system with no regulation and in which the perceptions, of both second and third party users of public accounting services, of the quality of these services are grossly inaccurate, the impact on the overall efficiency of the capital market will be rather minimal. Indeed, we have not come across any concrete evidence to suggest that higher quality public accounting services have had a dramatic or even a detectable impact on the financial markets' assessments of the value of a particular company or group of companies. Therefore, even if users of accounting services are ignorant, the level of ignorance does not appear to be overly important

for the aggregate performance of the economic system and particularly the performance of the capital markets.

In light of the preceding discussion, there appears to be only one recommendation that we can make: de-licensure of public accounting in Ontario. On this recommendation, the right to practise public accounting in Ontario would no longer be exclusive to those registered with the Public Accountants Council or any other regulatory body: the practice of public accounting would, legally, be open to all. Under our proposed system, accounting bodies such as the Institute of Chartered Accountants and the Certified General Accountants Association of Ontario would continue to grant designations and to establish and maintain what they judge to be appropriate standards of practice among their membership. The importance of the "CA", "CGA", or other accounting designation, then, would be as a signal in the market. The value of a designation would depend upon the reputation of the designated group for skill (training), or credibility, or promptness - a reputation which would be developed both by word of mouth and by deliberate informative advertising by accounting bodies. Private firms ought also to be allowed to engage in informative (but not price) advertising, regarding the qualifications of their members, the promptness of their service, etc. Users of financial information and clients of accountants would respond to the signals of different accounting designations according to the reputations of those designations, and according to their own preferences for credible

and/or prompt information, or for particular levels and mixes of accounting services.

To argue for a retention of licensure in the public accounting field, we would need to be convinced that (1) users of public accounting services are indeed extremely ignorant, and thus far we have not been convinced of this; (2) the degree of ignorance does make a substantial difference for the functioning of the capital markets and, in turn, the economy, and here again, we have not come across any evidence to suggest that this is the case and (3) a public accounting licensing body can, in effect, establish the optimal minimal quality standards for the profession, and here too, we have not come across any convincing evidence.

Lacking any convincing evidence supporting the basic arguments underlying the need for licensing of public accounting in Ontario, we feel that de-licensure is warranted. We do not believe that the onus is on us to develop a definitive case in support of de-licensure. Rather, we believe that the onus rests upon those groups that favour licensing to demonstrate the superiority of their regime, over a regime of de-licensure and informative advertising, in terms of a better economic performance. In our opinion, in light of the information that we have available, although a strong case cannot be made for the superiority of de-licensure, we do believe that a better and more convincing empirical and theoretical case can be made

in support of de-licensure than in support of licensing. Furthermore, given the many uncertainties, the many imperfections and the remaining unanswered questions, as well as the host of other market imperfections that exist in the economic system, it is highly unlikely, given the theory of second-best, that it will ever be possible to develop a definitive position regarding the appropriate degree or form of regulation in any given segment.

FOOTNOTES TO CHAPTER 4

1. Suboptimal from an aggregate economic perspective.

2. Even if the various conditions set out by Professor Spence are met, and because of user misperceptions, the economic system is operating suboptimally, at least in terms of allocative efficiency, one could counter using the theory of second-best that there is no need for regulation. Regulation aimed at increasing the levels of quality of service purchased in order to better approximate the optimal position might not move the entire economic system any closer to the pareto optimal position. In light of the theory of second-best, it is possible that regulation aimed at optimizing quality levels purchased in the accounting industry might, in fact, lower aggregate social welfare and move the economic system further away from pareto optimality.

3. See for example Alan J. Winters, "Unaudited Statements: Review Procedures and Disclosures" Journal of Accountancy, (July, 1976), pp. 52-59.

4. We see no value in permitting price advertising, since price per hour, quantity and quality of service and final billing rates need not be closely associated and hence there is greater scope for price advertising to be misleading.

5. As an example, it is possible to argue that, at the present time, several of the major New York banks are technically insolvent since many of the loans that they have made to underdeveloped countries will never, in fact, be recovered. This is not entirely accurate for while they may never be recovered from the countries to which the loans were made, there is no doubt that the federal government will step in and either pay the interest obligations on these loans or repay the principal in full to the major New York banks. In the absence of such action by Washington, there could be a collapse of the entire financial system in the U.S. Yet, audits of these major New York banks do not report and indeed cannot report that a certain faction of the loans outstanding will never be recovered.

CHAPTER 5

AN ARGUMENT FOR LICENSURE OF PUBLIC ACCOUNTING IN ONTARIO

Daniel B. Thornton

Pericles of Athens is reputed to have said in 430 B.C., "although only a few may originate a policy, we are all able to judge it." To this one might add that it is much easier to criticize an existing policy than to recommend changes for improvement. I am in the position of criticizing not only the current regime, but also the recommendations of my colleagues for improvement. It became apparent mid-way through this project that the three co-authors would not be able to agree on recommendations, even though we agreed on most points of methodology. We viewed this difference of opinion as a strength rather than a weakness of this report, since its object was never to put forward one perfect solution to the licensure problem in Ontario, but to speculate as intelligently as possible about the effects of different regulatory regimes. The healthy debate that took place amongst us served to sharpen our arguments, and, we hope, make the report a much better one.

If an opportunity for Pareto improvement exists in society, there will be some effort to exploit it. The one way to exploit it is to set up a market. If the market is impractical, another social device may be tried: government intervention, codes of professional ethics, or economic organ-

izations that act as intermediaries between competitive economic agents and the government. I believe that it is clear from Chapter 1 that society is better off because of the existence of public accounting. The view that will be developed here is that a market for public accounting services is indeed impractical, however, unless there is first some assurance of a minimum level of quality produced by vigorous monitoring of strict professional ethics. Licensure appears to be the best way to achieve this. Equally impractical, though, is the "from-now-on" type of solution that was tried in the early 1960's: that is, the policy of licensing several existing groups now, but only CA's from now on.

WHY THE MARKET SOLUTION IS IMPRACTICAL FOR ONTARIO

This section presents an argument that a 'free market' solution would not be a practical way of allocating public accounting services in Ontario. That is not to say that the market solution could not work in other jurisdictions: for example, it seems to be working in Alberta. The critical difference between the two provinces is that we in Ontario have lived with a licensing regime for many years now, whereas Alberta has never required licensing of public accountants. As a result, various institutions have developed in Ontario that are not present in Alberta. These include both explicit institutions, such as the Public Accountants Council, and implicit institutions, or rules of thumb, that govern the way public accounting functions in the province. The costs of changing these institutions

drastically would, arguably, be enormous; the benefits are highly uncertain and very difficult to quantify.

Perfect competition has always held great attraction for economists, because, as the reader may be aware, the optimization conditions for perfect competition in an economy are identical to the conditions for Pareto optimality: a blissful state in which no one can be made better off without making someone else worse off. In the neoclassical economic model, this result follows from some very important assumptions about markets and the behaviour of economic agents. The most important assumption, is that each individual in the economy has perfect information. 'Information' is interpreted here in the strict sense of being a symbolic representation of reality, or a decision model that the economic agent can use to make his resource allocation decisions. Information consists of a utility function, perhaps a production function, and the prices of all of the commodities or factors of production that enter into the decision. Moreover, prices, as Hayek[1] points out, convey all of the relevant information possessed by all of the other decision-makers in the economy, since they are the collective result of their tastes and constraints. The market aggregates the individual decisions and the terms of trade are adjusted until the decisions of each individual are consistent in total: supply equals demand.

The principal objection to the market solution for public accounting

services, in my opinion, is that the participants in the market have very poor information. Their information is so poor that they can scarcely define the commodity under consideration. As a result, they are ill-informed about the price and quality tradeoffs that might be made. And if they make mistakes, it is most likely to be some third party user of public accounting reports that will be hurt by them. Another objection is that the cost of wholesale reform of the public accounting institution in Ontario would probably be infinite. Opponents of this view may point to other jurisdictions in which unregulated regimes appear to be operating satisfactorily. But the reason that this seems to be so is that in most jurisdictions licensing is now in effect; because of this, public accounting is carried on in the unlicensed provinces almost as if licensing were in effect there too. This 'spill-over' effect is due to the fact that most large corporations have offices in both licensed and unlicensed provinces, and so, therefore, do most large public accounting firms. These large firms to some extent set the tone for the practice of public accounting in the province. If all provinces were now unlicensed, the practice of public accounting in Alberta would probably be very different from what it is today.

The remainder of this section constitutes an elaboration of the argument that the market solution is impractical for Ontario. In particular, I shall trace out the probable ways in which the practice of public accounting would change in response to various exogenous shocks, on the basis of the evidence that has been

collected in this report.

The 'Nirvana Approach'

Demsetz[2] has warned of the pitfalls of the 'Nirvana Approach'. This approach is characterized by the advocacy of complete re-structuring of an existing regime to make it compatible with some theoretical ideal. Popper[3] writes of the desirability of piecemeal social engineering as opposed to complete social reform. The basic idea put forth by both of these scholars is that it is almost impossible to foresee the effects of reforming many or all of our social institutions simultaneously. It is far more prudent to reform one at a time, so that the others can be taken as more or less given in the analysis. Complete de-licensure of public accounting in Ontario would be a very drastic change, not only for Ontario itself, but for the rest of Canada as well because of the relative commercial importance of this province. It is very difficult to predict what might happen in this case, but some speculations are suggested below.

Lack of Information

It seems clear from the evidence which has been collected that most users and clients do not understand what public accountants do. Therefore, they are unable to assess the quality of an audit or other public accounting service. This lack of information constrains their tastes and makes it very unlikely that their

decisions would result in an efficient allocation of public accounting resources.

Low quality public accounting is very difficult to detect. Typically, public accounting firms' procedures have been subject to scrutiny only when their clients have failed. This means that there is some documentation of audit failures in which too little service was rendered, but none for audits in which too much was rendered. There is virtually no publicly available information on the performance of non-audit engagements. The difficulty in measuring performance stems largely from the fact that the performance of the client is stochastic (random) after the service has been rendered. As a result, bad service could easily go unnoticed for many years; and even when something goes wrong, it is very difficult to trace it to the public accountant. To a large degree, then, we must rely on the ethics of practitioners to render the 'right' amount of service.

Clients and users have devised certain rules of thumb to choose public accounting firms that will render the 'right' amount of service. Generally, size and reputation of the public accounting firm have served as signals for quality. Because quality is virtually unobservable on the demand side of the market, some very large firms with established reputations have developed on the supply side. In fact, the public accounting profession is unique in having such a large range of firms by size. The

large ones have in-house professional development programmes, quality reviews, and many specialists who are available to assist the staff. As a result, the level of expertise is far higher in these few large firms than in the small ones. The view taken here, however, is that it is quite possible that the rule of thumb may be faulty: these large firms can just as easily provide a client with too much service as a small one can provide him with too little. We also found some evidence that small firms make up for their lower level of expertise by providing more timely service.

In sum, both clients and users must trust public accountants to provide the appropriate level of service. Of course, ethics would still exist in a more competitive market, but the economic incentives would be very high for practitioners to engage in what can be labelled "Darby - Karni Behaviour."[4]

Darby - Karni Behaviour in a Competitive Market

Darby and Karni[5] have analyzed the economic incentives that exist for someone providing a service in a competitive market when buyers have difficulty evaluating the quality of the service. They use as an example automobile tune-ups. The performance of the car is stochastic (random) after the tune-up, so if it fails to perform well it is difficult to blame the mechanic. Alternatively, if it runs satisfactorily, it is quite possible that far too good a tune-up was done. The analogy to the market for public accounting services is obvious.

When there are many clients in the service queue, there is an economic incentive to underserve each of them to maximize one's income. On the other hand, when there are no clients in the service queue there is an economic incentive to overserve the one you have. This would be easy to do for a public accountant: he could convince his client that he had to do more work to express a certain opinion on the financial statements or sell him some ancillary service that he did not need. Both of these situations are unsatisfactory. Again, the client must trust that his public accountant is providing him with the 'right' amount of service. The free market solution would encourage, though not necessarily result in, this Darby - Karni behaviour. It is possible that many clients are receiving the wrong level of service now in the 'professional ethics' regime: but if so, it is likely because the public accountant is not aware of what the appropriate level of service is, not because he is trying to maximize his income. This can be corrected with education and professional development courses, whereas Darby-Karni behaviour is very difficult to monitor.

Adverse Selection on the Demand Side

Akerlof[6] has analyzed the situation in which market participants have different information bases. In the public accounting market, it is clear that the seller (the public accounting firm) has a lot more information about the product (service) than the client. Buyers in this situation can judge quality only by the average level of quality in the market, since sellers all look

the same. (Earlier, it was argued that size can, but does not necessarily, serve as an appropriate discriminator. Then the argument developed here would apply within a size segment.)

In such a market, buyers with inferior products are encouraged to offer them for sale, whereas those with superior ones are discouraged. The market is ruined, ultimately, by this behaviour. If public accounting were freely competitive, high quality practitioners might be driven from the market, and ultimately clients would be offered only the poorest service. Numerous practitioners have told us they feared that if the public accounting market were opened up, bad standards would drive out good ones. The argument developed here provides an economic, as opposed to an intuitive, rationale for this fear.

Adverse Selection on the Supply Side

Akerlof's model is equally valid in the market for professional skills. A high quality practitioner will not wish to stay in a labour market in which his abilities are neither appreciated nor rewarded: that is, a market in which he is treated as if he were 'average'. Public accountants are very mobile. They can easily leave public practice and work in industry; in fact, half of the CA's in the province now do so. But they can also move from the small to the large firm market segment, where it is more likely that technical competence will be rewarded. Therefore, in a free market regime, I would envisage a significant amount of adverse selection on the supply side,

especially in the small practitioner segment where the informational asymmetries between practitioner and client are the most pronounced. This would exacerbate the disparity that now exists between the levels of expertise of large and small firms, and perhaps drive some excellent practitioners from the market entirely.

Fee Competition

The Cohen Commission asserted that "the Commissions' research suggests that time pressure generated by unduly low fees and by arbitrary deadlines are the most significant cause of substandard performance of auditors."[7] There is no doubt substantial truth to this view. If there is excessive fee competition among public accountants, standards may suffer a great deal. In the short run, there will be an economic incentive to render too little service for the given fee. In the long run, professional incomes may suffer and fewer high quality students will be attracted to the profession. This might be especially serious for small firms. As Spence[8] indicates, the great objective is to keep fees high enough to attract quality practitioners and encourage high quality service, but not so high as to choke off demand for the service. I have no idea how to determine this optimum, but it is safe to assert that free competition in the market for public accounting services would probably not determine it.

The Cohen Commission noted another element of fee competition

that we found in our work (see Chapter 2): "There are allegations... that firms sometimes offer relatively low fees for the first year or the first few years of an audit, with the expectation of recovering the initial loss in subsequent years."[9] This, of course, gives the auditor implicitly a financial interest in the success of his client and might influence or appear to influence his independence in carrying out his duties as a public accountant. We have no idea how widespread this practice is at present, but it does exist. Under free competition, this sort of practice would be encouraged.

There is some evidence that there is quite a lot of price competition among firms in a given market segment already, but that it is not observable by clients and users.[10] We have the impression that competition is somewhat more fierce in the United States than in Canada.

My general conclusion here, then, is that too much price competition can be just as damaging to the public accounting market as too little. Within a segment, the firms offer a basically undifferentiated product, so the environment for price competition is very hospitable.

The Return to Innovation

A competitive regime may reduce the return, and hence the incentive for innovation. Innovation is taken here to mean the

development of some new accounting service or the reduction in costs of providing an existing service.

The reason for this seeming paradox is that clients and users would not be able to distinguish a cost reduction occasioned by innovation from one that resulted from merely providing a lower quality service.

Search Behaviour

In Chapter 2 we developed a search model in keeping with those of Stigler,[11] McCall,[12] Gastwirth,[13] and Telser.[14] When price information is imperfect it is perfectly logical for different economic agents to pay different prices for the same commodity. Generally, the agents who search the longest will pay less, but they will have expended more resources searching.

In the market for public accounting services, search is very expensive: especially for small clients, who could be doing business instead of searching. In addition, they are least able to distinguish quality differences. In essence, they must search for price and quality simultaneously. Realizing that the task is very costly, it appears from our research that they give up the ghost rather soon: most contact only one or two public accounting firms before selecting one. As a result, it is in this market segment that informational asymmetries are most serious and adverse selection most probable on both the demand and supply sides of the market.

Remoteness of Users

The Cohen Commission concludes that in public capital markets "the user has no opportunity to know, to consider, or to directly influence any tradeoffs made between price and quality."[15] In the small business segment, where firms do not sell their securities to the public, we found that banks sometimes are influential users in the selection of a firm's public accountant. Usually, though, the assertion of the Cohen Commission is valid. Therefore, users have some right to expect that the public accounting standards used are of proper quality. At the very least, they are entitled to assume that some minimum quality standards were applied. The free market regime would not guarantee even this minimum level of quality. The licensed regime will not guarantee it either, but there are at least weaker economic incentives to skimp on quality on the supply side.

Ambiguity of Contracts

Enforceable contracts are a necessary institution in any well-functioning market. The view developed here is that it is impossible to have them in the market for public accounting services. The reason is that the extent of the professional service is unknown until the engagement has been accepted: no auditor can sell an unqualified opinion for $1,000; or a unit of credibility for $100. He can only sell his time, and the amount of time he will have to spend on a given engagement is unknown until he has already begun it. Moreover, the amount of time he

will spend depends upon his ability and the effort he will put forth. This situation makes the free market solution even less likely to work, and adds another dimension to the client's ignorance about the service he is buying.

Confrontation between Accountant and Client

It is costly for clients to meet the professional accountant standards that have been developed to protect the public. In a free market regime, the client would have much more bargaining power vis-à-vis the accountant. It might even be possible to 'shop around' for an accountant who would be amenable to the suggestion that certain standards were not really as important as others. Therefore, competition might put pressure on the public accountants to lower their standards from the demand side.

Learning Impractical

Free market proponents assert that all we need to do is make sure that all of the accountants are certified: that is, that they display their designations when they perform public accounting services. Then the economic agents observe the world and learn, by Bayes Theorem or by some psychological learning process, the probabilities that CA's, CGA's, etc. will do work at various quality levels. This assumes, of course, that the world has the same structure over time (that a 'stable stochastic process' is being observed). It also assumes that everyone observes all relevant facts, that all bear the 'costs of rational calculation', and that their tastes are independent of their

beliefs.

I believe this argument to be fallacious in the context of the market for public accounting services. Users and clients would have to keep track records of all CA's, CGA's, etc. and apply them rationally over time. The view developed above was that it would be difficult enough for rational men to decide whether a single audit was done poorly, adequately, or too well.

RECOMMENDATIONS

The argument developed here is that the free market solution will not work because it is impractical, and the "from-now-on" solution will not work because there are just too many non-CA accountants in Canada who are practising and will continue to practise public accounting. How, then, should a licensing regime be structured in Ontario?

The ultimate form of the licensing arrangement will be decided by government, through a process of consultation among various interests. No doubt many alternatives will be considered in this process. Two possibilities are outlined below.

Alternative #1: License only CA's, once and for all

The rationale for this action would be that the professionals themselves are best able to figure out how to match supply and

demand for services in the various market segments. However, it denies the existence of CGA's in Ontario and cuts off a potentially valuable source of manpower.

Alternative #2: Establish a licensing board that will allocate practitioners to market segments, regardless of designation.

Such a board would function much as the Auditor Certification Board in British Columbia, except that it would license all forms of public accounting, not just auditing. The board would have lay, government, and professional representation, and would consider each application on its own merits.

A prime consideration would be the intended clientele of the person applying for a licence, and the kind of work he wished to do.

This would be a very expensive regime, in terms of administrative and enforcement costs. To reduce the costs somewhat, the board might consider de-licensure of non-review engagements totally.

If licensure is retained, the licences granted should not be valid indefinitely. A serious problem with the present regime, in my view, is that it is too easy for CA's to obtain licences, especially when they have obtained their designations long ago. I would envision renewal of licences every five years, on demonstration that adequate standards were being maintained by the practitioner. Practitioners who wished to re-apply for

a licence after years of absence would have to take some refresher courses and perhaps pass a qualifying examination.

Most important, each professional body - CA's, CGA's, etc. - would monitor the performance of their practitioners vigorously and demonstrate to the board and the public that the standards being applied by its practitioners were adequate for the markets that they were serving.

FOOTNOTES TO CHAPTER 5

1. F.A. Hayek, "The Use of Knowledge in Society", American Economic Review (1945), vol. 35, pp. 519-530.

2. Harold Demsetz, "Information and Efficiency: Another Viewpoint", Journal of Law and Economics (1969), pp. 1-22.

3. Sir Karl R. Popper, The Open Society and Its Enemies, vol. 2 (London: Routledge & Kegan Paul: 1945).

4. See Michael R. Darby and Edi Karni, "Free Competition and the Optimal Amount of Fraud", Journal of Law and Economics (1973), vol. 16, p. 67-88.

5. Ibid.

6. George A. Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism", Quarterly Journal of Economics (1970), vol. 89, pp. 488-500.

7. AICPA, Commission on Auditors' Responsibilities (New York: American Institute of Certified Public Accountants, 1977).

8. Michael Spence, Entry Conduct & Regulation in Professional Markets, Working Paper #2 prepared for the P.O.C. (1978).

9. AICPA, supra note 7, p. 117.

10. See for example, "Touche Ross Openly Strives for Growth As Accounting Firms Turn Competitive", Wall Street Journal October 5, 1976.

11. George Stigler, "The Economics of Information", Journal of Political Economy, (1961), vol. 69, pp. 213-225.

12. J.J. McCall, "The Economics of Information and Optimal Stopping Rules", Journal of Business, University of Chicago, (1965) vol. 39, pp. 300-17.

13. Gastwirth, J.L., "On Probalistic Models of Consumer Search for Information" (unpublished paper), (John Hopkins University and the National Science Foundation (1971).

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15. AICPA, supra note 7, p. 108.

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